Monitoring Report in 2017

July 2017

Certified Public Accountants and Auditing Oversight Board

Table of Contents

Introduction

In July 2016, the Certified Public Accountants and Auditing Oversight Board ("CPAAOB") published "Recent Trends in Audit Firms (Monitoring Report in Fiscal 2016)" with the aim of providing an overview of the audit landscape in an easy-to-understand way not only for audit and account experts but also for ordinary users.

Since the role of accounting audits in capital markets is becoming increasingly important, we believe it vital to enable as many stakeholders as possible, including enterprises and shareholders, to be able to properly assess audit quality at audit firms. Last year's edition mainly comprised data to aid in the understanding of the situation with audit firms, and served as a supplement to the Case Report from Audit Firm Inspection Results ("case report").

For this year's edition, we have revamped and augmented the data, and incorporated materials and information that the CPAAOB has obtained through its recent monitoring activities, including inspections, the collection of reports, and interviews. This has made the content far more extensive. We have published this Monitoring Report in 2017 separately from the case report for increasing public access. We hope that you utilize it.

On March 31 this year, the Financial Services Agency ("FSA") published the Audit Firm Governance Code, and as a result, the situation with audit firms, including large audit firms and second-tier audit firms, has changed considerably as they endeavor to reorganize and strengthen their governance. The CPAAOB intends to continue to enrich the content of our monitoring report including articles regarding the recent developments.

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(Definitions of terms)

Terms used in this report shall be defined as follows:

○The term *Act* refers to the Certified Public Accountants Act.

○The term *FIEA* refers to the Financial Instruments and Exchange Act.

○The term *QCSCS* refers to Quality Control Standards Committee Statement No.1.

○The term *ASCS* refers to Auditing Standards Committee Statements.

○The term *monitoring* refers to both on-site and off-site monitoring. On-site monitoring refers to inspections, while off-site monitoring refers non-inspection activities such as the collection of reports from and the conduct of interviews with audit firms and the collection of information through information exchanges, cooperation with audit firms and related parties.

○The term *fiscal year* refers to the year starting in April and ending in March of the following year, unless otherwise stated.

○The term *program year* refers to the year starting in July and ending in June of the following year.

○The term *audit firm* refers to audit firms, partnerships, and individual firms.

○The term *large-sized audit firm* refers to an audit firm that has more than approximately 100 listed audited companies and whose full-time staff performing actual audit duties total at least 1,000. In this report, they specifically refer to KPMG AZSA LLC, Ernst & Young ShinNihon LLC, Deloitte Touche Tohmatsu LLC and PricewaterhouseCoopers Aarata LLC.

○The term *second-tier audit firm* refers to an audit firm whose size of business is second only to large-sized audit firms. In this report, they specifically refer to GYOSEI & CO., BDO Sanyu & Co., Grant Thornton Taiyo LLC, BDO Toyo & Co., PricewaterhouseCoopers Kyoto and YUSEI Audit & Co.

○The term *small and medium-sized audit firms* refers to audit firms other than large-sized audit firms and second-tier audit firms.

○The term *JICPA* refers to the Japanese Institute of Certified Public Accountants.

○The term *stock exchange* refers to a financial instruments exchange.

○The term *domestic listed company* refers to a listed company other than a foreign listed company.

○The term *Big Four accounting firms* refers to Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers.

(Note of Sources)

Where sources are not indicated, the information has been prepared based on data on audit firms obtained by the CPAAOB in the course of its monitoring activities.

I. Overview of Quality Control at Audit Firms

Ⅰ. Overview of Quality Control at Audit Firms

A. Outline of Laws and Regulations and Systems Regarding Audit Firms

1. CPA System

Since the promulgation of the Securities and Exchange Act (renamed the Financial Instruments and Exchange Act in 2006) in 1948, issuers of securities have been obliged to undergo external audits. Simultaneously, the Act was promulgated and the certified public accountant system has been introduced in response to a need for professionals in auditing and accounting.

The Act stipulates that the mission of certified public accountants (CPA), as professionals on auditing and accounting, shall be to ensure matters such as the fair business activities of companies, etc., and the protection of investors and creditors by ensuring the reliability of financial documents and any other information concerning finance from an independent standpoint, thereby contributing to the sound development of the national economy (Article 1 of the Act).The Act requires a CPA to provide services with fairness and integrity from an independent standpoint under Article 1-2 of the Act, and the Act and the FIEA prescribe various measures to ensuring CPA's independence.

Auditing standards[1] also state that "The auditor shall maintain integrity and objectivity, and shall not have any specific interest that may impair his or her independence, nor have an appearance that may lead others to suspect the independence when performing an audit" (General Standards 2).

Qualification of CPA is: pass the CPA examination and fulfillment of certain requirements such as completing an internship and professional accountancy education program, and then registration on the CPAs list, which is maintained at the JICPA (Article 3, 17, and 18 of the Act) (See Ⅱ. Overview of the Audit Sector, A. CPAs, Figure Ⅱ-1-1 for information on the number of registered CPAs.).

1 Auditing standards were first published in 1950, and were revised in 1956 in conjunction with the start of legitimate audits of financial statements. Since then they have continually been revised by the Business Accounting Council. The most recent revisions were made in 2014.

Under the cabinet office ordinance[2], CPAs must receive training provided by the JICPA in order to enhance the quality of their work. The JICPA institutes the continuing professional education system (CPE system) aiming that CPAs fulfill their mission and improve the quality of audit services in response to the provision of the cabinet office ordinance. CPAs must submit a report to the JICPA every year on the results of the training they have completed. CPAs who fail to fulfill their training obligations may be subject to disciplinary actions (See III. Operation of Audit Firms, B. Education, Training, and Evaluation for Audit Firm Personnel for information on education and training at audit firms.) .

2. Audit Firm System

The audit firm system was established following an amendment to the Act in 1966, the aim of which was to promote organizational audits conducted by multiple auditors. The amendment followed a series of corporate scandals that had begun in 1964 and also reflected the fact that audit and attestation services were expanding and becoming more complex with expansion in size and diversification in company's business.

In January 1967, the first audit firm was established, and there are 222 audit firms as of March 31, 2017 (See II. Overview of the Audit Sector, B. Audit firms, Figure II-2-1 for details.).

An audit firm is a corporation that is co-founded by CPAs to perform audit and attestation services in an organized manner. It shall have five or more CPAs as partners (Article 34-7 (1) of the Act). Moreover, an audit firm shall, when it has been incorporated, notify the prime minister (his/her authority is delegated to the Commissioner of the FSA in accordance with Article 49-4 of the Act) (Article 34-9 (2) of the Act).

The CPAAOB classifies audit firms into three categories according to the scale of their business such as the number of listed companies they audit, the number of staff and their operating revenues. These three categories are large-sized audit firms, second-tier audit firms, and small and medium-sized audit firms (See "Definitions of terms." In the figures, they are denoted as large-sized, second-tier, and small and medium-sized.).

[2] The Cabinet Office Ordinance on Continuing Professional Education provided for in Article 28 of the Certified Public Accountants Act.

■System of Limited Liability Audit Corporations ■

The civil liability of audit firm partners is unlimited as the firms are organized as partnerships, and all partners generally assume joint liability for the repayment of debts that cannot be repaid from the firm's assets alone.

The 2007 amendments to the Act permit the establishment of limited liability audit firms in light that audit firms are limited-liability companies in most other countries, and given such factors as the emergence of large-sized audit firms in Japan.

As of April 26, 2017 there were 23 registered limited-liability audit firms.

With regard to all the attestations that the firm carries out, a limited-liability audit firm assigns designated limited liability partners to be in charge of services, and notifies audited companies of the designations (specified attestation). If the obligations assumed by the firm with respect to the specified attestation cannot be discharged using the firm's assets, the designated limited-liability member and the firm assume joint liability for them.

Limited-liability audit firms are subject to a registration system, and there are minimum capital requirements and a deposit system in place to provide a sufficient financial base to ensure the protection of creditors.

3. Services of CPAs and Audit Firms

The services of CPAs and audit firms are prescribed by the Act as follows:

- Audit and Attestation Services: Audit or attest financial documents for fees at the requests of clients. Only CPAs and audit firms can provide audit and attestation services (Article 2-1 of the Act). CPAs and audit firms conduct both statutory audits, which are performed pursuant to regulations, and non-statutory audits that are not performed pursuant to regulations. Statutory audits include audits conducted pursuant to the Companies Act and the FIEA as well as audits of incorporated educational institutions with government subsidies. Since FY2017, social welfare corporations that meet certain criteria have also been obliged to undergo statutory audits.
- Non-Audit Services: Compile financial statements, examine or plan financial matters, or to be consulted on financial matters for fees at the requests of clients, using the title of a CPA or audit firm (Article 2-2 of the Act).

An audit firm shall develop the operation control structure comprising the following components in order to ensure service quality and perform its services fairly and accurately (Article 34-13 of the Act):

- Measures for securing the fair execution of services
- Formulation and implementation of policy on service quality control
- Measures for eliminating the possibility of persons other than partners who are CPAs from having an inappropriate influence on the execution of audit and attestation services

The operation control structure that audit firms are required to develop is described in detail in the next section, "B. Quality Control at Audit Firms."

4. Election and Dismissal of Accounting Auditors

The Companies Act obligates the following companies to undergo audits by accounting auditors (Article 326-328 of the Companies Act):

- Large companies
- Companies with audit committees and companies with nominating committees
- Companies for voluntary appointment of accounting auditors

An accounting auditor shall be a CPA or audit firm (Article 337-1 of the Companies Act).

Accounting auditors shall be elected by resolution of a shareholders meeting, and may be dismissed at any time by resolution of a shareholders meeting (Article 329 and Article 339 of the Companies Act). At a company with company auditors or board of company auditors, they prepare a proposal for the election, dismissal, or refusal of reelection of an accounting auditor to a shareholders meeting (Article 344 of the Companies Act).

Directors shall obtain the consent of the company auditors or board of company auditors in cases where the directors fix the remunerations for accounting auditors (Article 399 of the Companies Act).

Article 340 of the Companies Act stipulates that the company auditors may dismiss an accounting auditor if that accounting auditor:

- has breached his or her duty in the course of his/her duties, or neglected his/her duties;

- has engaged in misconduct inappropriate for an accounting auditor; or
- has difficulty in, or is unable to cope with the execution of his/her duties due to mental or physical disability.

The Corporate Governance Code, which was issued in May 2015, stipulates that company auditors or board of company auditors should establish standards for the appropriate selection and proper evaluation of accounting auditors. The Japan Audit & Supervisory Board Members Association issued “Practical Guidelines for the Establishment of Standards for the Evaluation” in November 2015. It provides a checklist when company auditors and board of company auditors evaluate and select accounting auditors.

5. Communication between Accounting Auditors and Company Auditors Etc.

Accounting auditors need to communicate with company auditors matters concerning the audits they have conducted at every phase, from the planning and conduct of audits to the reporting of audit results. Details of the communication that the accounting auditors and company auditors should engage in are described in “Communication with Company Auditors, Etc.” (ASCS260).

With regard to matters concerning the execution of duties by accounting auditors, in addition to the reports they make to company auditors, etc., under Article 131 of the Rules of Corporate Accounting, accounting auditors must make a request for rectification to the company auditors if they discover fraud, etc., at audited companies. When corrective action is not taken, they must consider reporting it to the Commissioner of the FSA in accordance with Article 193-3 of the FIEA.

6. Japanese Institute of Certified Public Accountants (JICPA)

The purpose of the JICPA shall be to maintain the professional attitude of CPAs, to give guidance, to liaise with, to supervise its members in order to achieve the improvement and progress of the services set forth in Article 2 (1) of the Act, and to maintain the registration of CPAs and specified partners (Article 43 of the Act).

A CPA or an audit firm shall become a member of the JICPA (Article 46-2 of the Act) and needs to be registered with the relevant regional chapter of the JICPA (16 regional chapters nationwide as of July 2017). (Note that information on the situation with the registration of CPAs and audit firms is presented in II. Overview of the Audit Sector, A. CPAs.)

B. Quality Control at Audit Firms

1. Design of a Quality Control Structure by Audit Firms

An audit firm shall develop the operation control structure pursuant to the provisions of a Cabinet Office Ordinance in order to perform its services fairly and accurately. The operation control structure shall include the formulation and the implementation of policy on service quality controls (Article 34-13 (1), (2) of the Act).

The service quality controls mentioned above are specifically prescribed as taking the necessary measures for preventing the occurrence of situations that would impair the appropriateness, fairness or credibility of services concerning the below matters (Article 34-13 (3) of the Act, Article 26 of the Ordinance for Enforcement of the Certified Public Accountants Act).

- Compliance of professional ethics and independence
- Acceptance and continuance of engagements
- Employment, education, training, evaluation, and appointment of partners and other professionals
- Implementation of engagements and engagement quality control reviews

The quality controls that audit firms and their personnel that conduct audits must comply with are prescribed mainly in the following standards:

- Quality Control Standards for Audit
- Quality Control for Audit Firms (QCSCS)
- Quality Control Related to Audit Services（ASCS220）

When implementing the FIEA audit, audit firms are required to conform to the *Quality Control Standards for Audit*.

The JICPA has set *Quality Control for Audit Firms* (QCSCS) as rules related to quality control that audit firms, members of the JICPA, shall comply with. The JICPA has also set *Quality Control Related to Audit Services* (ASCS220) as the rules related to quality control that the personnel that perform audit services shall comply with.

The items included in QCSCS are as follows:

- Application and compliance of related requirements
- Composition of the system of quality control
- Responsibilities for quality controls
- Professional ethics and independence
- Acceptance and continuance of engagements
- Employment, education, training, evaluation, and assignment of personnel (assignment of the engagement team)
- Performance of engagements (provision of expert advice in response to inquiries, engagement quality control reviews, differences in audit judgments, and audit documentation)
- Monitoring in relation to quality control (monitoring of the audit firm's policy and procedures related to quality control, assessment of identified deficiencies, communication and remediation, appeal of an objection and raising of a doubt)
- Documentation of the system of quality control
- Transfer of audit engagements between audit firms
- Joint audit

Within the above-mentioned items, we will explain the acceptance and continuance of engagements, engagement quality control reviews, and monitoring of the audit firm's policy and procedures related to quality control as they are closely related to the content of this report.

a. Acceptance and continuance of engagements

Audit firms shall set the policy and procedures for the acceptance and continuance of engagements with audit clients (QCSCS (25)).

- Audit firms have capabilities and aptitudes to perform audit services including time and human resources.
- Audit firms can comply with the relevant ethical requirements.
- Audit firms have to consider the integrity of audit clients and to ensure that there are not significant concerns about the acceptance and continuance of engagements.

(See III. Operation of Audit Firms, C. Acceptance of New Audit Engagements and Changes in Auditors for details.)

b. Engagement quality control reviews

Audit firms shall, in principle, set the policy and procedures for engagement quality control reviews to objectively assess audit procedures, important audit judgments, and audit opinions issued by the engagement team in expressing audit opinions at all audit services (QCSCS (34)).

Specifically, it is necessary to prescribe the execution of the following (QCSCS (36)):

- Discussion with an engagement partner about important issues
- Review of financial statements and auditor's report draft
- Consideration of important judgments made by engagement teams and the audit documentation regarding the conclusion
- Assessment of the audit opinion and the appropriateness of the audit's report draft

(See III. Operation of Audit Firms, F. Engagement Quality Control Review for details.)

c. Monitoring of the audit firm's policy and procedures related to quality control

Audit firms shall set the process for monitoring in relation to quality control to rationally ensure that the policy and procedures related to the system of quality control are appropriately and sufficiently designed and effectively operated (QCSCS (47)).

The process includes monitoring by the audit firms themselves and global reviews by a global audit network.

(See III. Operation of Audit Firms, G. Monitoring in System of Quality Control for details.)

2. Quality Control Review by the JICPA

A quality control review shall be conducted by the JICPA to monitor the status of the operation of audit and attestation services in accordance with Article 46-9 (2) of the Act. The JICPA reviews audit firms in light of their status including audit quality control and makes recommendations for improvement to audit firms as necessary. This system went into operation in 1999. Since the amendment of the Act in 2003, the JICPA has had to report the results of these reviews to the CPAAOB periodically or as needed.

The JICPA reviews whether maintenance of audit firm's system of quality control is appropriate, adequate and conformed to quality control standards such as the QCSCS and the ASCS with regard to audit quality control performed by audit firms at the quality control review. The JICPA also assesses the state of the system of quality control and its operation by testing some selected items in a population in order to ensure that it is being operated effectively. The quality control review is conducted once every three years in principle for each member audit firm. When it is deemed necessary, JICPA shortens the cycle of its review by once every two years, etc.

There are two types of quality control review. This first is the regular quality control review. This covers the status of quality control at the audit firm as a whole and is conducted regularly or on an ad-hoc basis. The second is the special quality control review, which is conducted when a situation has arisen that threatens social confidence in audit. It is performed whenever necessary, and covers quality control in relation to the specific areas of activity or to specific audit services that relate to the issue[3].

[3] For details concerning quality control reviews, see the JICPA website and the annual report from the quality control committee.

C. Monitoring by the CPAAOB

1. Overview

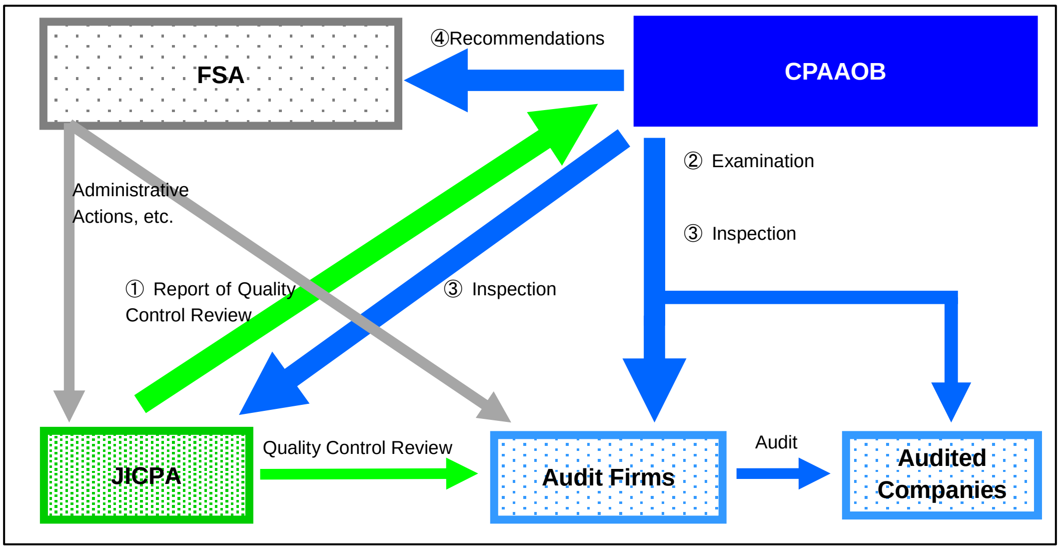
The CPAAOB is an administrative body that serves as a council and is established in accordance with Article 35 (1) of the Act and Article 6 of the Act for Establishment of the Financial Services Agency.

The CPAAOB's main responsibilities are to administer the CPA examination, conduct examinations and inspections of audit firms and consider and deliberate on disciplinary action against CPAs and audit firms.

The CPAAOB comprises a Chairperson and a maximum of nine Commissioners who are appointed by the Prime Minister with the approval of both Houses. They are selected from among persons with understanding and insight relating to CPAs.

The CPAAOB conducts inspections or collects reports where those are deemed to be necessary and appropriate from the viewpoint of protecting public interests and investors as a result of the examination of the JICPA's quality control review reports. Furthermore, the CPAAOB shall recommend to the Commissioner of the FSA that administrative actions or other sanctions be imposed if necessary (Figure I-3-1).

Figure I-3-1: Overview of examinations and inspections



a. Report of quality control review

The JICPA reviews conformance with laws/regulations, audit standards and JICPA bylaws on an ex post facto basis and makes a report on its reviews to the CPAAOB.

b. Examinations

The CPAAOB receives reports from the JICPA and mainly examines that the JICPA's quality control review system is being administered appropriately and that audit services are being properly conducted by audit firms.

During the examination process, the CPAAOB may ask the JICPA or audit firms to submit reports or materials if it deems necessary.

c. Inspections

If the CPAAOB deems it necessary and appropriate in order to protect public interest and investors, it conducts inspections of audit firms and other necessary places (e.g., audited companies).

Moreover, if it is deemed necessary in order to ensure the appropriate administration of the JICPA, the CPAAOB conducts inspections of the JICPA (See 5. Inspections of and Collection of Reports from Audit Firms.).

d. Recommendations

If it is deemed necessary based on the results of examinations or inspections, the CPAAOB recommends administrative actions or other measures to the Commissioner of the FSA if there should be any taken to ensure the appropriate administration of audit services by audit firms and of the JICPA.

■Background to the Establishment of the CPAAOB and Cooperation with Related Bodies in Other Countries■

From October 2001, the Financial System Council's Certified Public Accountant System Subcommittee at that time studied the desirability of the CPA system. These studies were aimed at ensuring confidence in and improving the function of Japanese capital markets, which are exposed to the global economy. The background was international developments such as the response by the U.S. governments to corporate scandals relating to accounting fraud. The studies led to the amendment of the Act, and this saw the CPAAOB's predecessor, the Certified Public Accountants Oversight Board, reorganized and amplified as the CPAAOB in April 2004.

Similarly, Auditing oversight bodies, which operate independently of accounting professionals, have been established in various countries, and this created the opportunity to establish an international association aimed at information exchange among the auditing oversight bodies. As a result, the International Forum of Independent Audit Regulators (IFIAR) was launched by 18 countries including Japan in September 2006. As of March 31, 2017, IFIAR counted 52 countries/regions as members (the Japanese participants are the CPAAOB and the FSA).

The CPAAOB and the FSA urged establishment of a permanent secretariat in Tokyo as a means of contributing to the enhancement of international audit quality through IFIAR and boost Japan's influence in international financial regulation, including that covering audit. These efforts bore fruit, and the decision was made to establish a permanent secretariat in Tokyo in April 2016. The secretariat opened in April 2017.

2. Basic Policy for Monitoring Audit Firms and Basic Plan for Monitoring Audit Firms[4]

a. Basic Policy for Monitoring Audit Firms

Since the CPAAOB was established in April 2004, it has formulated a Basic Policy for Monitoring each term (three-year period). The CPAAOB published "Basic Policy for Monitoring Audit Firms" as the policy for the fifth term, from April 2016 to March 2019 (issued in May 13, 2016; hereinafter referred to as the "Basic Policy for Monitoring"). The monitoring viewpoint and purpose expressed in the Basic Policy for Monitoring is summarized below:

[4] The Basic Policy for Monitoring and the Basic Plan for Monitoring, including previous versions thereof, are available on the CPAAOB's website and in its annual report.

(1) Viewpoint

The CPAAOB will conduct monitoring that is effective and efficient with due consideration of audit firms, and will actively endeavor to ensure confidence in auditing by maintaining and improving the quality of audits.

Furthermore, the CPAAOB will actively provide useful information such as sector-wide issues, which are identified as a result of analyzing the information obtained through monitoring, to relevant parties such as the JICPA and the FSA and will also provide more information to the general public.

(2) Purpose

The purpose of monitoring is to ensure the proper audit services provided by audit firms. Monitoring will focus in particular on encouraging audit firms to take autonomous action, given that audit firms play the dominant role in maintaining and improving audit quality.

Monitoring will also emphasize not only conformance with auditing standards superficially, but also whether the audit firm maintains and improves audit quality substantively such as exercising appropriate professional skepticism that can detect accounting fraud.

Inspections will focus on the following:

i) To maintain and improve the quality control structure, the CPAAOB will inspect if measures for securing the fair execution of services prepared by audit firms correspond to the size and characteristics of the audit firm.

ii) The CPAAOB will inspect if audit firms appropriately assess business risks, including the economic environment and the corporate environment surrounding the audited companies, and implement appropriate audit procedures.

iii) The CPAAOB will precisely convey the inspection report and items pointed out in the results of the inspection that will help such audit firms take action to make effective improvement based on root cause analysis.

b. Basic Plan for Monitoring of Audit Firms

The CPAAOB formulates the Basic Plan for Monitoring of Audit Firms (hereinafter referred to as the "Basic Plan for Monitoring") each program year in line with the Basic Policy of Monitoring. An overview of this plan for the program year 2016 is as follows:

(1) Basic plan for off-site monitoring

(a) Verification of quality control reviews by the JICPA

While focusing on the quality control review system, which encompasses the effectiveness of quality control review, the CPAAOB examines the JICPA's policies and actions to improve audit quality as a self-regulatory organization (SRO).

The CPAAOB endeavors to maintain effective cooperation with the JICPA by continuously exchanging information with quality control reviewers. The CPAAOB and the JICPA also discuss how best to allocate roles between them in consideration of the JICPA's responses to enhancing effectiveness of quality control reviews.

(b) Collection of reports

- Ongoing collection of reports from large-sized audit firms

The CPAAOB continuously asks for the quantitative and qualitative information it needs to examine the business management (governance) environment and operations management environment through the collection of reports. It uses the information obtained to make inspections more effective and efficient and to analytically compare the large-sized audit firm under inspection with other large-sized audit firms and to identify common problems within the firms.

- Collection of reports from second-tier audit firms and small and medium-sized audit firms which are not subject to on-site inspections

The CPAAOB collects reports on operation of audit services in a timely manner as a means of encouraging the audit firms to embed the appropriate audit quality controls.

In addition to development of the system of quality control at audit firms, which were found pervasive quality control issues in the previous reviews or inspections, the CPAAOB also focuses on examining sector-wide problems seen at small and medium-sized audit firms while taking into account the characteristics of each audit firm.

- Collection of reports on improvements made following inspections

If necessary, the CPAAOB collects a report from the audit firms, which have received inspection results, after the elapse of a certain period of time since the previous inspections, and also conducts an interview with them in order to confirm and inspect their quality controls.

(2) Basic inspection plan

Key points of this plan include (1) inspecting whether audit firm's management policy and business management measures are appropriate to its size and characteristics (2) inspecting whether audited company's business risks are appropriately assessed and proper audit procedures are being followed. The CPAAOB also places emphasis on encouraging audit firm's voluntary action to effective improvements that address root causes, and conducts inspections as follows:

(a) Large-sized audit firms

Large-sized audit firms are subject to regular inspections based on the consideration of their roles in the capital markets and domestic and international trends concerning auditing and oversight. Inspections are also conducted on an ad-hoc basis when there is a demand for swift verification such as a serious accounting fraud is found at an audited company which has a significant impact on markets.

In program year 2016, the CPAAOB will inspect with emphasis on: business management environment and operations management environment, the degree of embeddedness on quality control in all audit firms, audit procedures relating to revenue recognition and accounting estimates, and the status and audit procedures concerning environment and independence relating to IPOs.

Furthermore, the CPAAOB conducts follow-up inspections in the program year following the regular inspection to verify that improvements have been made in light of enhancement of follow-up after inspections.

(b) Second-tier audit firms

The CPAAOB conducts regular inspections which are designed to be effective and efficient by focusing on common risks. The CPAAOB put a high priority on inspection of this category of firms in light of the importance in Japan's auditing industry as well as in consideration of their audited companies and characteristics. As is the case with large-sized audit firms, ad-hoc inspections are also conducted when necessary.

In program year 2016, the focus will be on risks individual audit engagements bear. Inspections will look at fundamental problems with operation of services as well as business management environment and operations management environment, such as oneness as an organization.

(c) Small and medium-sized audit firms

The CPAAOB inspects firms in this category as necessary, focusing on the confirmation of audit quality. For example, the CPAAOB looks at the audit firm's quality control and operations management environment, which reflects the ambitions, personalities of representatives and partners, and conformance with auditing standards for individual audit engagements.

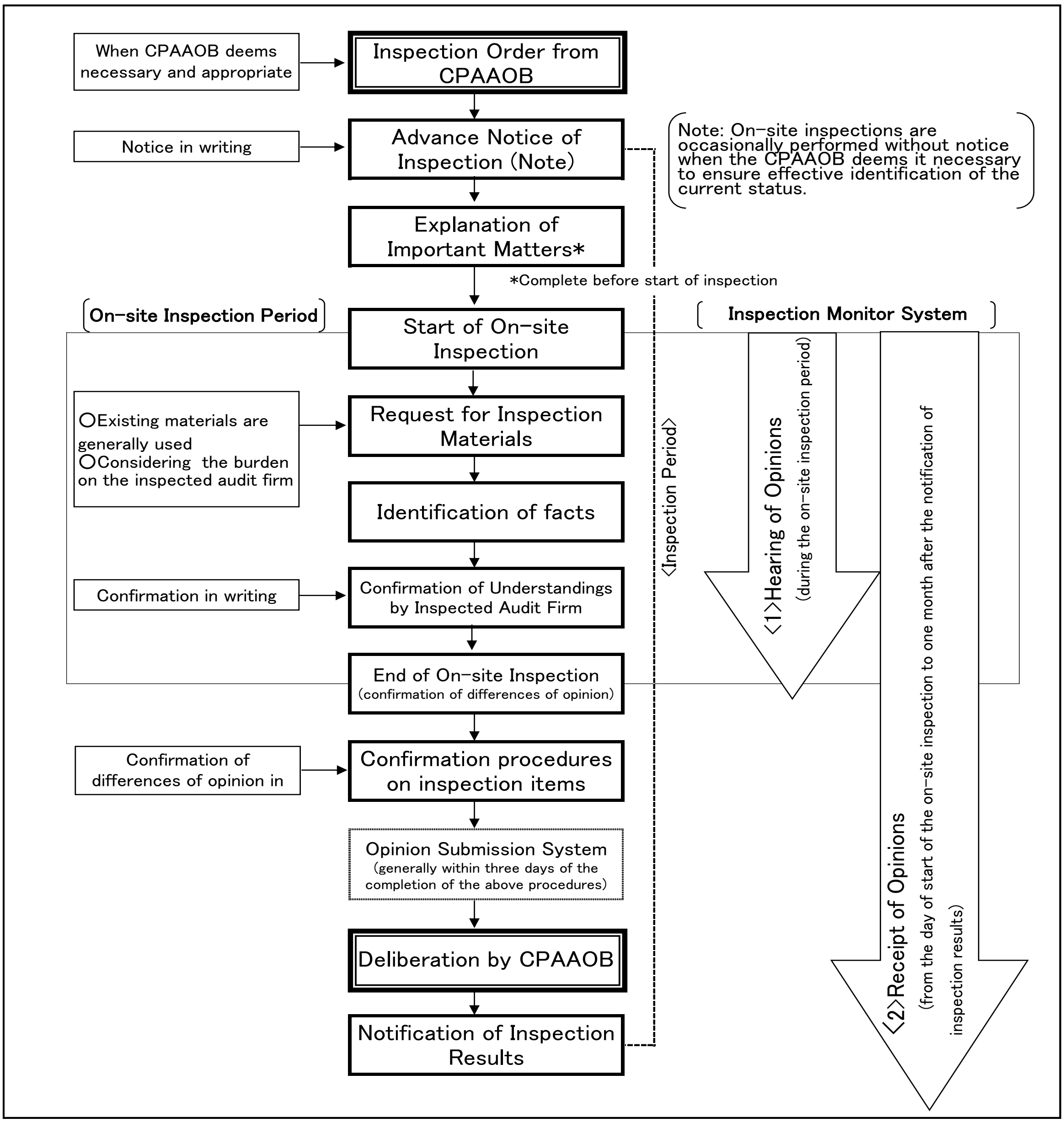
In program year 2016, the focus of inspections will be on: problems with their operation of services and quality control that stem from the structure of the audit firm and on the matters whether the firm possesses sufficient audit resources to deal with audit risks that relate to the internationalization of audited companies.

3. Inspection Workflow

Basic points on the CPAAOB inspections, inspection procedures, and the handling of inspection results are described in the “Basic Guidelines on Inspections Conducted by the Certified Public Accountants and Auditing Oversight Board” (April 2015; hereinafter referred to as the “Basic Guidelines”).

Based on the Basic Guidelines, the standard workflow for inspections is as follows (Figure I-3-2):

Figure I-3-2: Standard workflow for inspections



- Inspection order from the CPAAOB

The CPAAOB issues an order to inspect an audit firm to inspectors.

- Explanation of important matters

Before the date of the on-site inspection, the inspectors explain to the responsible person of the audit firm the authority for and purpose of the inspection, the method of inspection, an overview of the inspection monitor system and the opinion submission system, and other necessary matters.

- On-site inspection

Generally, the inspectors visit the audit firm and inspect its quality control environment and individual audit engagements. The individual audit engagements covered by the inspection are selected based on the consideration of the size of the audit firm, the key points of the basic inspection plan, and audited company's audit risks.

Inspectors examine whether the audit firm's procedures on quality control comply with regulations, auditing standards and quality control policies established by the audit firm through inspection of accounting books and other materials and interviews of personnel including engagement partners and partners and professional staff who work with engagement partners.

Furthermore, inspectors obtain the confirmation of facts and backgrounds (findings) identified during the inspection in writing from the responsible person of the inspected audit firm.

- Confirmation procedures on inspection items and opinion submission system

Once the on-site inspection has ended, the CPAAOB confirms with the audit firm matters where differences of opinion exist (the confirmation procedures on inspection items). If there are differences of opinion, the audit firm may submit its opinion in writing, basically within a three-day period since the day when the confirmation procedures on inspection items were completed (opinion submission system).

- Inspection monitor system

With the aim of maintaining and improving the quality of the CPAAOB inspections and ensuring the transparency of procedures, the audit firm may state its opinions concerning inspections.

Details of inspections performed at audit firms of different sizes are as follows. The CPAAOB appoints an inspection team based on the size of audit firms and their quality controls, and determines the scope and period of inspections (Figure I-3-3).

Figure I-3-3: Numbers of inspectors, periods of inspections, and nos. of individual audit engagements selected

	Total	Large-sized (regular inspections)	Second-tier	Small and medium-sized (No recommendation)	Small and medium-sized (Recommendation)
No. of inspections	54	10	7	25	11
Average no. of inspectors	6.2	9.9	7.4	5.0	5.0
Average no. of days for inspection	125.3	137.9	107.3	94.5	191.3
Average no. of individual audit engagements selected (no. of audited companies)	4.2	7.8	5.4	2.8	3.5

Note 1: Covers inspections conducted during the five-year period from fiscal year 2012 to program year 2016. Excludes follow-up inspections.

Note 2: Inspections began on the inspection date (in the case of inspections with advance notice; the date on which notice of the inspection was made; in the case of inspections with no advance notice; the date on which the on-site audit began) and ended on the date on which notification of the inspection results was made.

Note that follow-up inspections on large-sized audit firms have been performed since program year 2016. The goal of follow-up inspections is to verify that improvements have been made since the previous inspection, and they are conducted in an efficient manner. For example, the scope of the inspection is limited and the inspection results notification is simplified.

4. Notification of Inspection Results

a. Inspection results notification

The responsible person of the audit firm is notified of the results of the inspection in writing (the inspection results notification).

The current inspection results notifications contain the following information:

1. Key points
2. Inspection viewpoints
3. Deficiencies in measures developed by the inspected audit firm to ensure the proper execution of services with the aim of maintaining and improving quality control (quality control environment)
4. Deficiencies in the conduct of audit services (individual audit engagements)

The “Key points” section provides an overall rating (see below) and an overview of deficiencies with the operations management environment, the quality control environment and individual audit engagements. It also describes matters identified by the CPAAOB during the inspection to serve as a reference that the inspected audit firm determines root causes of the deficiencies and responses to them.

b. Overall rating

The overall rating of operation of services on the inspected audit firm is presented as follows in the “Key points” section of the inspection results notification:

Example of a “Key points” section:

1. Key points
As a result of our inspection of your audit firm, we discovered the following issues, which relate to the operation of your firm, within the scope of our inspection.
(1) Operations management environment
... (presents problems with its governance and operation of services)
(2) Quality control environment
... (presents deficiencies in the system of quality control)
(3) Individual audit engagements
... (presents deficiencies in audit services)

The CPAAOB has included the overall rating of audit firm’s operation of services in the inspection results notification since the inspections commenced in program year 2016. The aims are to accurately convey the CPAAOB’s assessment to audit firms and to contribute to deepen understanding of the level of quality control among the company auditors to whom the inspection results notification is provided.

The overall rating takes the form of one of the following five grades, and is based on the results of the assessment of the audit firm’s operations management environment, quality control environment, and individual audit engagements:

1 “Generally satisfactory”
Given when operation of services is deemed to be satisfactory. E.g., there are almost no deficiencies with respect to the quality control environment and individual audit engagements.

2 “Satisfactory with minor deficiencies”
Given when there are issues needed to be fixed, but operation of services is deemed to be satisfactory on the whole. E.g., there are no material weaknesses while there are some deficiencies with operations management environment, the quality control environment, or individual audit engagements.

3 “Unsatisfactory”
Given when operation of services is deemed to be unsatisfactory. E.g., there are material weaknesses with operations management environment, the quality control environment, or individual audit engagements that are needed to be fixed.

4 “Unsatisfactory and in need of immediate remediation”
Given when operation of services is deemed to be unsatisfactory and in need of immediate remediation.

5 “Extremely unsatisfactory”
Material deficiencies with the quality control environment and individual audit engagements were identified and voluntary remediation cannot be expected to be implemented by an audit firm.

With regard to the eight inspections that commenced in program year 2016 and for which the inspection results notification has been issued, rating 2 was given to five firms and ratings 3, 4, and 5 were given to one firm each. The CPAAOB makes recommendations to the Commissioner of the FSA when we assess audit firms as rating 5.

c. Handling of inspection results

The CPAAOB does not publish inspection results notifications[5]. Furthermore, the CPAAOB obtains a pledge from the inspected audit firm that it will not disclose the results to a third party when we conduct an on-site inspection.

However, the inspected audit firm may disclose the results without the prior consent of the CPAAOB in the following cases:

- When submitting them to the JICPA in accordance with rules concerning the handling of inspection results notifications that are prescribed in the rules of the JICPA quality control committee.

- When the inspected audit firm distributes the following information in writing to the company auditors of audited companies[6]
  - Whether there were any findings concerning the design and operation of the audit firm's system of quality control, and if there were, the summary thereof
  - In cases where audited companies were subject to the inspection, whether there were any findings with respect to the audited companies, and if there were, the details thereof

In cases other than the above, the audit firm is required to submit an application in advance to the CPAAOB in case that it disclose inspection results to third parties. Recently, requests for the disclosure of the results of the CPAAOB inspections have been increasing, as they can serve as a tool for confirming the details of the design and operation of the system of quality control at audit firms. Therefore, the CPAAOB constitutes methods for prior consent for disclosure to a third party to the CPAAOB by

[5] Cases involving recommendations shall generally be published.
[6] According to QCSCS, audit firms must inform company auditors of the content of inspection results notifications and the audit firm's responses to the issues identified in the results (QCSCS 260 (15-2), A22-3).

categories such as audited companies and potential audited companies.

For more details concerning the disclosure of inspection results to third parties, please visit the CPAAOB website.

Alteration of the content disclosed:
In the past, the documents used for disclosure to company auditors were prepared by each audit firm. The CPAAOB has reformed the “Key points” section in the inspection results notification in a plain format that enables the information to be used effectively by the company auditors of audited companies since program year 2016. The CPAAOB has also asked to deliver the content as is to company auditors.

5. Inspections of and Collection of Reports from Audit Firms

a. Inspections of audit firms

(1) Details of inspections

The frequency of inspection differs depending on the size of the audit firm. The CPAAOB has alternated between regular inspections and follow-up inspections for large-sized audit firms, while second-tier audit firms are generally subject to inspections once every three years since program year 2016. Small and medium-sized audit firms, meanwhile, are inspected as necessary upon examination of findings at quality control reviews, etc.

Details of the inspections conducted during the past five years are presented below (Figure I-3-4):

Figure I-3-4: Inspections conducted during the past five years (unit: number of audit firms)

Fiscal/program year	2012	2013	2014	2015	2016 (Notes 1 and 2)
Large-sized audit firms	2	2	2	2	4 (2)
Second-tier audit firms	1	2	1	1	2
Small and medium-sized audit firms	8	9	11	6	5
Foreign audit firms (Note 3)	0	0	1	0	1
Total	11	13	15	9	12 (2)

Note 1: The accumulation period has been changed to the program year (from July to June) from July 2016. The number of inspections conducted between April and June 2016 are also included in program year 2016 because the year was the transitional period.

Note 2: Figures in parentheses are the number of firms at which follow-up inspections were conducted (included).

Note 3: See III. Operation of Audit Firms, H. Foreign Audit Firms Etc. for information on foreign audit firms.

Note 4: Figures are the number of inspections that commenced in the years concerned.

(2) Deficiencies

The CPAAOB inspections are mainly designed to confirm and verify that the quality control environment for the audit firm as a whole and audit procedures for individual audit engagements conform to laws, regulations, and standards[7], and to determine deficiencies.

(a) Characteristics of deficiencies identified through inspections of quality control environment

At large-sized audit firms, hardly any deficiencies relating to formal aspects of the design of quality control structure have been detected in recent years. However, the inspections conducted in program year 2016 continued to reveal deficiencies with the operation of the structure.

As is the case at large-sized audit firms, the formal aspects of quality control structure at most second-tier audit firms are well developed. However, there were cases where the degree of quality control structure did not meet the scale to which the firm has expanded at audit firms that are expanding through mergers and acceptance of new audit engagements. In some cases, there is no management structure established at audit firm's headquarters. In addition, some audit firms did not equip an adequate quality control structure, for example, it has not made much progress on making their partners and personnel full time.

At small and medium-sized audit firms, the design and operation of the quality control structure is frequently influenced by the personalities of individuals, including the representative as a result of quality control for the audit firm being often left in the hands of a specific partner.

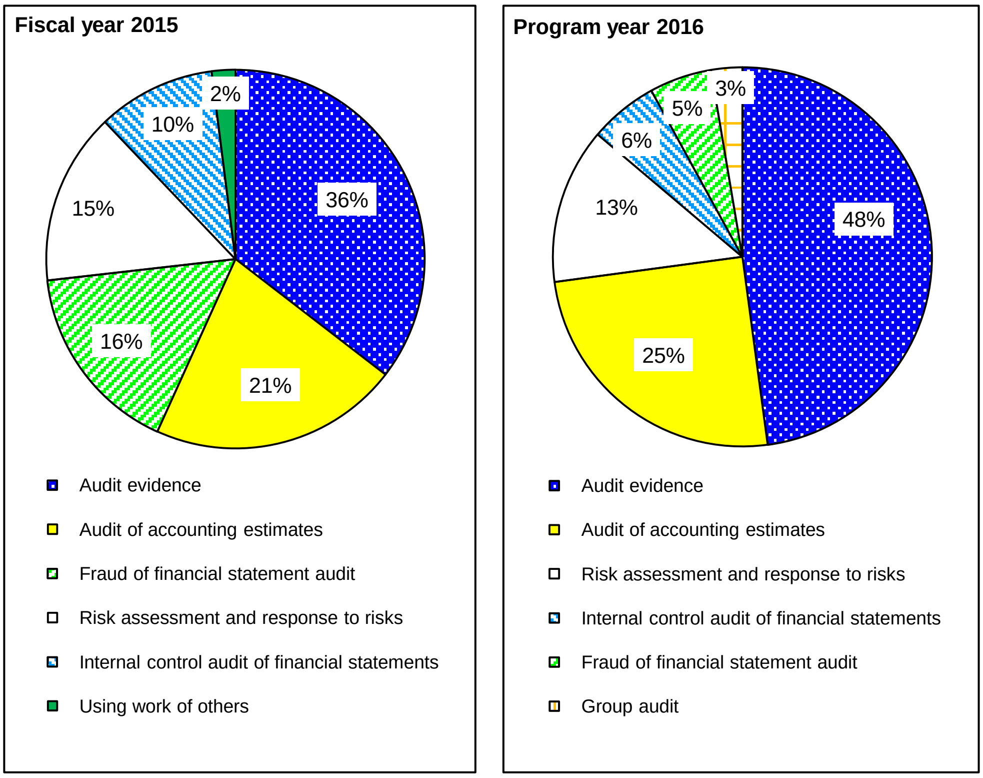
As the above discussion indicates, deficiencies were detected in both the design and operation of the system of quality control in program year 2016.

(b) Characteristics of deficiencies identified through inspections of individual audit engagements

Details of deficiencies identified through inspections of individual audit engagements in fiscal year 2015 and program year 2016 were as follows (Figure I-3-5):

[7] "Laws, regulations, and standards" include laws, regulations, the JICPA bylaws and rules, auditing standards generally accepted in Japan and Japan generally accepted accounting principles (Japan GAAP). See the Basic Guidelines for more details.

Figure I-3-5: Deficiencies in FY2015 and PY2016



Note 1: Based on deficiencies identified during inspections for which inspection results notifications were issued in the years concerned.

Note 2: “Audit evidence” indicates cases in which there were deficiencies in obtaining or assessing the audit evidence that forms the basis for the audit opinion.

Note 3: “Using work of others” in FY2015 includes “Group audit”.

The CPAAOB identified a large number of fraud-related deficiencies in fiscal year 2015 since we conducted inspections over accounting fraud. In program year 2016, considerable deficiencies were seen both at the audit planning stage, e.g., with risk assessments and responses to identified risks, and at the audit execution stage, e.g., with audit evidence and accounting estimates.

The CPAAOB also implements inspection aimed at encouraging the inspected audit firms to voluntarily improve their audit services by analyzing and sharing the causes of determined deficiencies through dialogue with the firms.

During an inspection of a small and medium-sized audit firm, for example, numerous and pervasive deficiencies were discovered with several individual audit engagements including their basic audit procedures.

The direct cause of these deficiencies was insufficient understanding and knowledge of auditing standards among the engagement team, including the engagement partner, and this means that the overall environment for the conduct of audits was weak. For example, engagement teams included newly-hired part-time CPAs or personnel who do not possess the CPA qualification. The CPAAOB found the following deficiencies on its operation of services after pursuing the exact cause of these deficiencies based on our findings:

- The CEO also did not acquire satisfactory understanding and knowledge of auditing standards.
- The CEO was unaware that the environment for the conduct of audits had been weak because the CEO mainly managed his/her group firm and dedicated efforts to expanding the range of non-audit services.
- The CEO and the person in charge of quality control have next to no actual involvement in quality control.

As the above case shows, it is important not only to point out individual deficiencies and the direct causes of them but also to encourage fundamental improvement by an audit firm by seeking root causes relating to operation of services after understanding common circumstances and problems throughout the audit firm.

For more details of deficiencies identified during inspections, please see the case report.

b. Collection of reports from audit firms

(1) Continuous collection of reports from large-sized audit firms

The CPAAOB collects all the qualitative and quantitative information required to inspect business management (governance) environment and operations management environment from large-sized audit firms at the same timing.

We analyze and utilize collected information to make our inspections more effective and efficient. This information is also used for comparative analysis and identification of sector-wide problems as also shown in this Monitoring Report.

In program year 2016, we collected reports on business management environment such as operations management environment, governance, domestic network structures and cooperation with global audit networks, as well as on quality control environment such as the management of risk information.

(2) Collection of reports from second-tier audit firms and small and medium-sized audit firms

From second-tier audit firms and small and medium-sized audit firms, the CPAAOB generally collects reports from audit firms that were subject to quality control reviews in the previous term, as a mean of urging audit firms to radicate appropriate audit quality controls.

We collected reports from 83 audit firms in program year 2016. The reports covered management policy, the revenue/financial structure of the audit firm, the organization/personnel of the audit firm, the design and implementation of training systems, global audit networks, and group audits, etc.

(3) Collection of reports following inspections

If necessary, the CPAAOB collects a report from audit firms in order to confirm and inspect improvements that have been made in response to the inspection findings after the lapse of a certain period of time from notification of inspection results. We work closely with relevant departments of the FSA to ensure that our confirmations and inspections reflect the nature and materiality of the deficiencies during this process. If, as a result of the report collection, insufficiencies in improvements of the deficiencies are found, we will consider collecting further reports.

Furthermore, we may interview audit firms which are subject to collection of reports if we find any concerns, and may consider how to deal with the concerns appropriately in light of the situation and risks at the audit firm concerned.

As a result of ex post confirmation and inspection, we consider conducting re-inspection at an early stage if we cannot find adequate and independent improvement action by the audit firm.

In the last program year, we collected reports from five of the audit firms[8] notified of the results of the CPAAOB inspections in program year 2016 in order to confirm that improvements had been made in response to the inspection findings.

[8] One of the audit firm's inspections was commenced in fiscal year 2015 and was concluded in program year 2016.

II. Overview of the Audit Sector

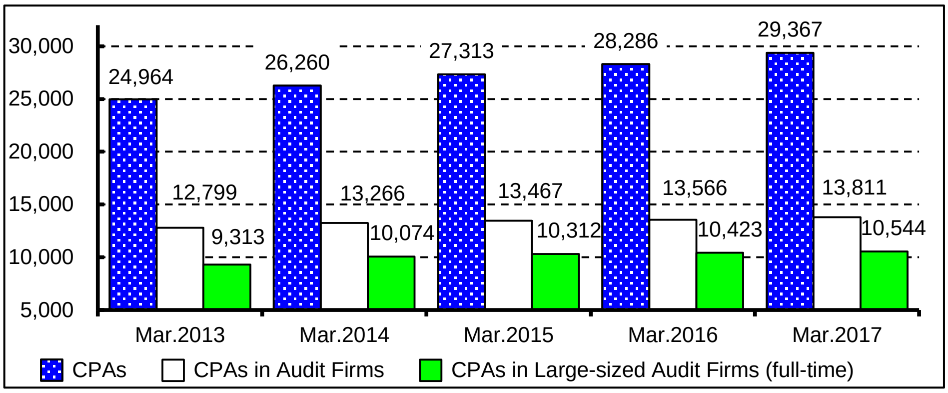
Ⅱ. Overview of the Audit Sector

A. CPAs

The number of registered CPAs has been gradually increasing for recent years. However, the number of CPAs who belong to audit firms remains around 13,000, and CPAs as a proportion of all CPAs is declining.

Approximately 76 percent of CPAs who work in audit firms belong to large-sized audit firms (Figure Ⅱ-1-1).

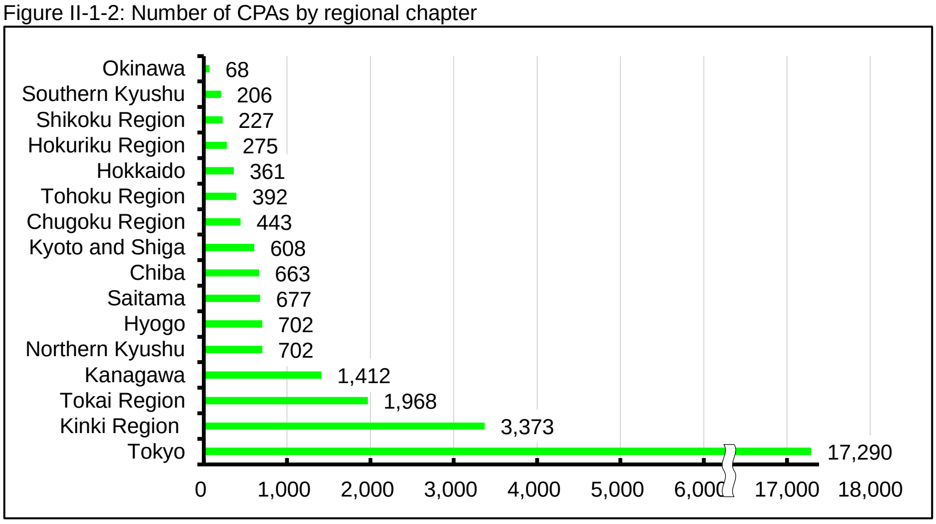
Figure Ⅱ-1-1: Change in the number of registered CPAs (unit: number of persons)



Source: JICPA, CPAAOB (The number of CPAs who belong to large-sized audit firms is the total number of CPAs in each audit firm as of March 31 of each year.)

Around 70 percent of CPAs work in the Tokyo metropolitan area, which includes Tokyo and Kanagawa (Figure Ⅱ-1-2).

Figure Ⅱ-1-2: Number of CPAs by regional chapter



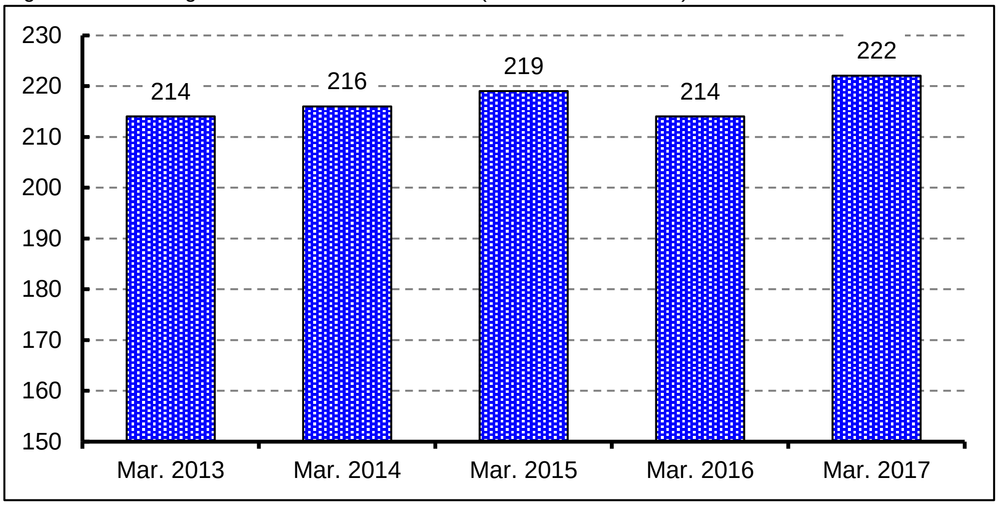
Source: JICPA (as of March 31, 2017)

B. Audit Firms

1. Change in the Number of Audit Firms

The number of audit firms has not changed significantly the last few years. A net increase of eight in the number of audit firms occurred since four firms were dissolved or absorbed through merger, and 12 new firms were established in the 2016 fiscal year (Figure II-2-1).

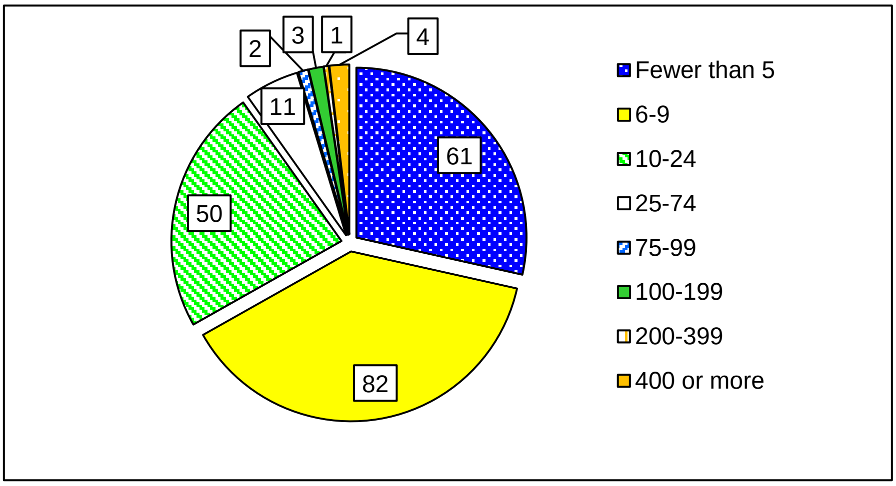
Figure II-2-1: Change in the number of audit firms (unit: number of firms)



Source: JICPA

The below chart shows the size of audit firms classified by the number of CPAs that belong to the firms. As shown in the figure, 90 percent of audit firms have fewer than 25 CPAs (Figure II-2-2):

Figure II-2-2: Number of audit firms in size category as measured by the number of CPAs that belong to the firms (FY2015, unit: the number of firms)



Source: Prepared from data on 214 firms obtained from their FY2015 business reports

2. Mergers

Since fiscal year 2012 there have been 11 mergers involving audit firms, and all the audit firms that were absorbed were small and medium-sized audit firms (Figure II-2-3). Reasons for the mergers included the aims to expand the firm or areas of service.

Figure II-2-3: Audit firms involved in mergers since FY2012

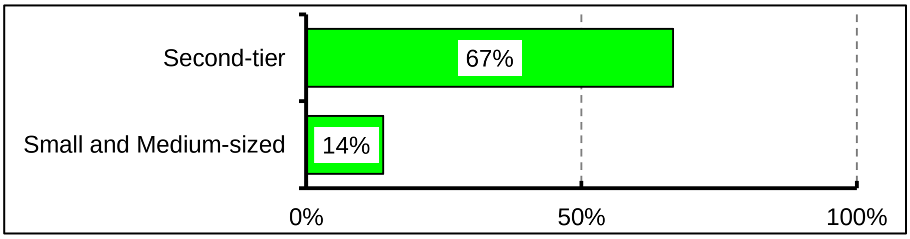
Fiscal year	Surviving audit firm
2012	Grant Thornton Taiyo LLC (Eisho Audit Corp.) Fukuoka Audit Corp. (Fukuhoku Audit Corp.)
2013	Grant Thornton Taiyo LLC (Kasumigaseki Audit Corp.)
2014	Gravitas Audit Corp. (Daido Audit Corp.) Hibiki Audit Corp. (Pegasus Audit Corp., Shinbashi Audit Corp.) GYOSEI & CO. (Meiwa Audit Corp.) SeishinShisei & Co. (Keiwa Accounting)
2015	SeishinShisei & Co. (Seishin Audit Corp.) Ark Meiji Audit & Co. (Ark Audit Corp.)
2016	Ark Meiji Audit & Co. (Hijiribashi Audit Corp.) Seiyo & Co. (Kudan Audit Corp.)

Note: Surviving audit firms are presented as their current names. The names of absorbed firms are presented in parentheses.

Source: Prepared from publicly disclosed materials from each audit firm

Whereas the majority of second-tier audit firms are considering mergers as part of their future business strategy, the proportion of small and medium-sized audit firms that are considering mergers is relatively small (Figure II-2-4). Furthermore, those firms considering mergers are comparatively large among small and medium-sized audit firms.

Figure II-2-4: Proportion of audit firms considering mergers (second-tier audit firms, small and medium-sized audit firms)



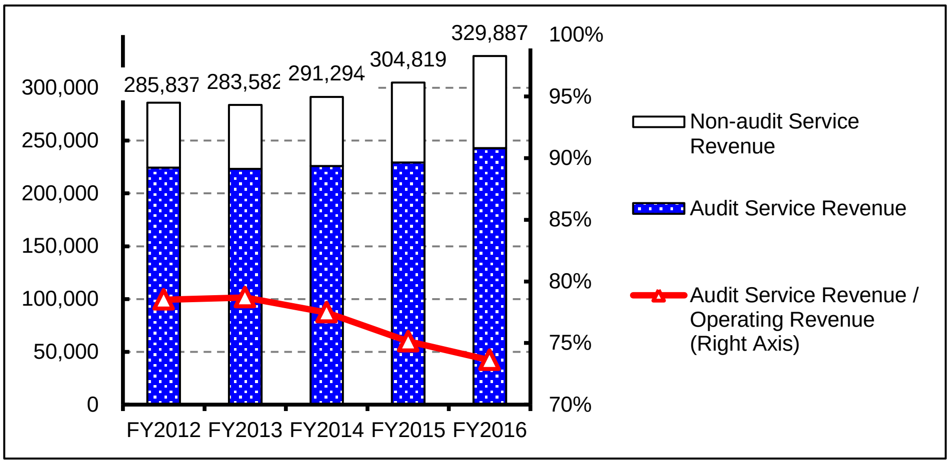
Note: Covers 50 firms that responded to this question in the reports collected from them in FY2016.

3. Finances (Operating Revenues and Proportions of Audit and Non-Audit Operating Revenues)

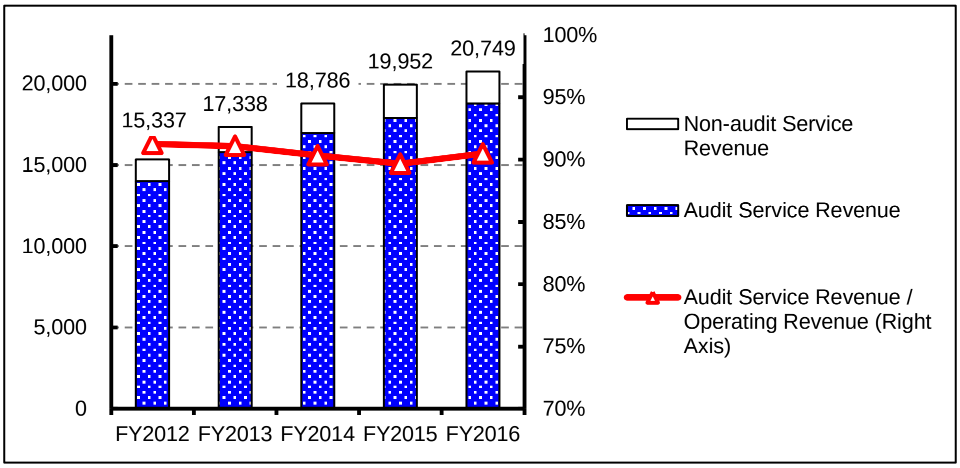
Audit firms offer non-audit services such as IPO advisory services, IFRS and accounting change services and M&A and organizational restructuring services other than audit and attestation services (Figure II-2-5).

Figure II-2-5: Change in breakdown of operating revenue and percentage of revenue from audit and attestation services (left axis, unit: JPY 1M)

<Large-sized audit firms (total of four firms)>



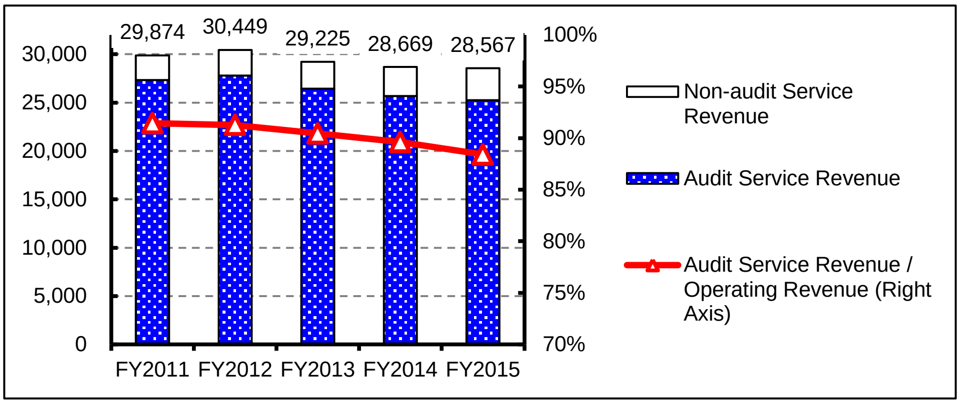
<Second-tier audit firms (total of six firms)>



Note 1: One firm had changed its fiscal term in FY2012, therefore, we accounted for only three-month revenue of the firm.

Note 2: For the firm that had changed its fiscal term in FY 2016, its operating revenue for FY2016 could not be determined. For this reason, this firm's FY2015 operating revenue was also used as its FY2016 operating revenue.

<Small and medium-sized audit firms (total)>



Note: Operating revenues of each audit firm, each year are added up. Regarding large-sized audit firms and second-tier audit firms, the data is gathered up to FY2016 and for small and medium-sized audit firms, it is gathered up to FY2015.

While total operating revenue declined at large-sized audit firms in fiscal year 2013, it has been increasing since then. At second-tier audit firms, it has been climbing since 2012. At small and medium-sized audit firms, on the other hand, it rose in 2012 but has been falling since then.

Looking at the breakdown of operating revenue, the proportion of revenue from non-audit services in operating revenue at large-sized audit firms is higher than that of second-tier and small and medium-sized audit firms. Revenue from audit and attestation services as a proportion of operating revenue has been decreasing because the increase in revenue from non-audit services has outweighed the raise in that from audit and attestation services.

Second-tier and small and medium-sized audit firms have depended heavily on audit and attestation services whose revenue provide around 90 percent of operation revenue. However, the trend regarding changes in the sources of operating revenue differs at the two types of firms.

At second-tier audit firms, both revenue from audit and attestation service and non-audit service are on the rise. In fiscal year 2016, thanks to an increase in the number of audited companies, the ratio of revenue from audit and attestation services has rebounded after falling until last year.

At small and medium-sized audit firms, audit and attestation service revenue as a percentage of the total has been falling since revenue from non-audit services has increased, while that from audit and attestation services has been on the decline.

C. Audited Companies

1. Audited Companies under the FIEA and the Companies Act and Listed Audited Companies

The CPAAOB analyzed audited companies that are subject to statutory audits under the FIEA or the Companies Act and listed companies that have a significant impact on capital markets.

a. Number of audited companies under the FIEA and the Companies Act and share for each type of audit firm

While there has not been any significant change in the number of audited companies under the FIEA or the Companies Act, the trend was downward until fiscal year 2013. In turn, the number has been increasing since fiscal year 2014 (Figure II-3-1). Regarding the share for each type of audit firm as measured by firm size, the share of second-tier audit firms has been climbing since fiscal year 2013 (Figure II-3-2).

Figure II-3-1: Change in number of audited companies under the FIEA or the Companies Act

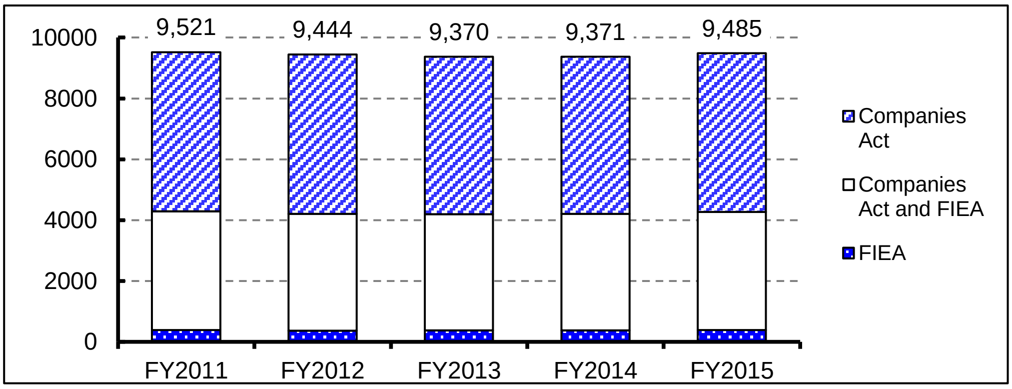
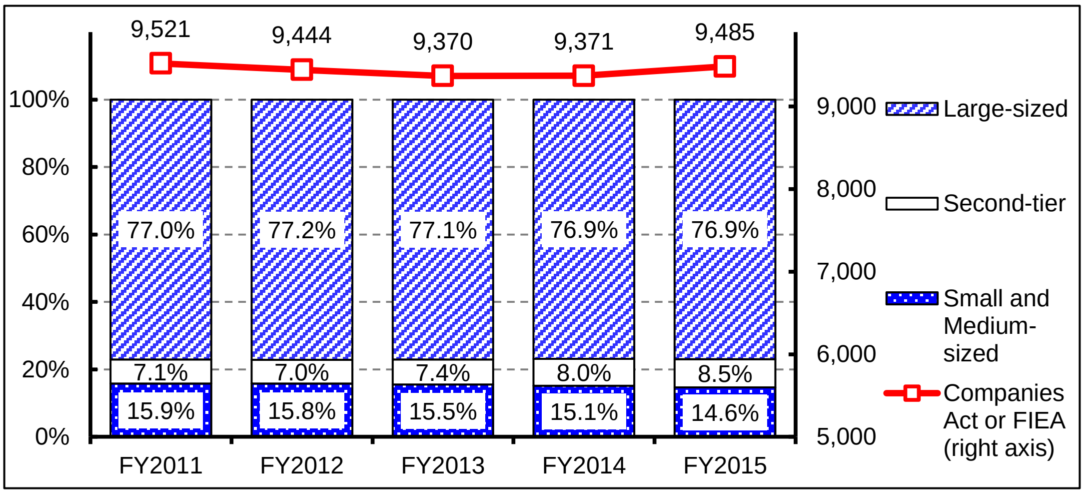


Figure II-3-2: Share of audited companies under the FIEA or the Companies Act by each type of audit firm

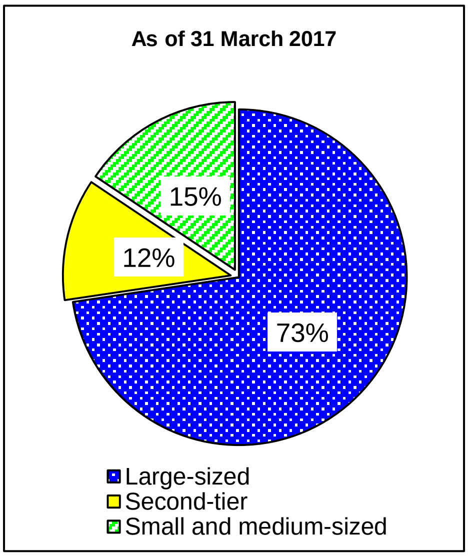


Note: Figures are based on the number of audited companies by audit firms each year.

b. Share of listed audited companies for each type of audit firm

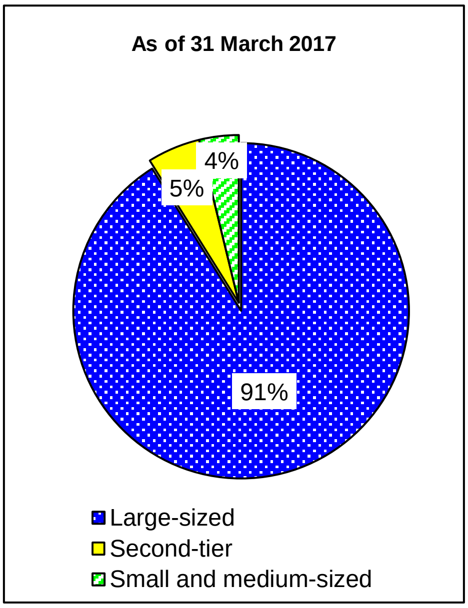
Approximately 70 percent of listed audited companies are clients of large-sized audit firms. The larger the company is, the more likely it is to be audited by a large-sized audit firm, these audit firms control more than 90 percent of the listed audited companies market in terms of market capitalization (Figure II-3-3, Figure II-3-4).

Figure II-3-3: Number of listed audited companies by each type of audit firm (unit: the number of company)



Large-sized audit firms	2,653
Second-tier audit firms	429
Small and medium-sized audit firms	570
Total	3,652

Figure II-3-4: Market capitalization of listed audited companies by each type of audit firm (unit: 100 million yen)

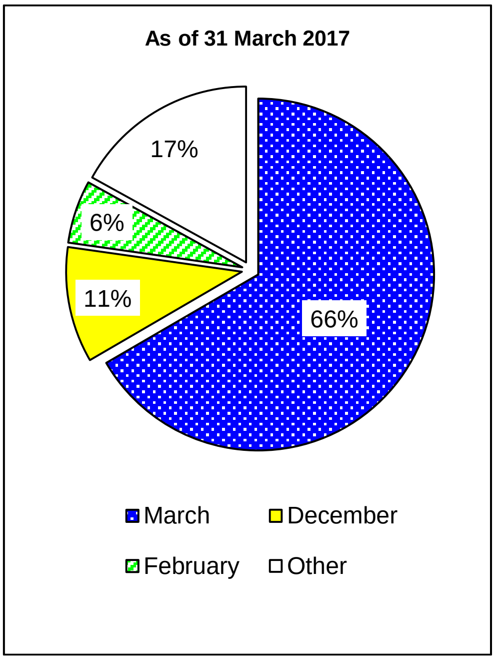


Large-sized audit firms	5,386,707
Second-tier audit firms	301,067
Small and medium-sized audit firms	225,271
Total	5,913,045

c. Number and market capitalization of listed audited companies by ending fiscal period

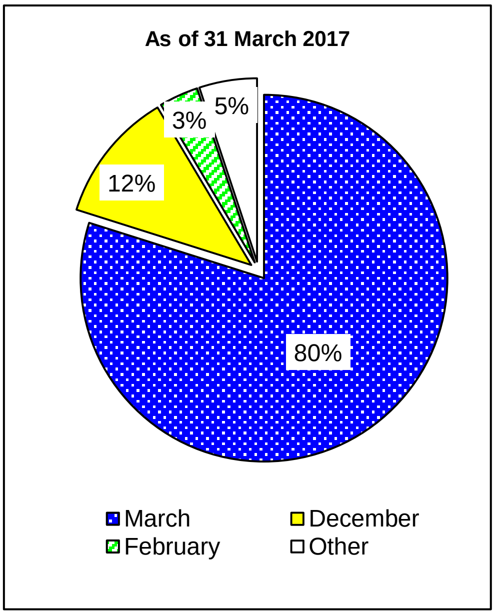
Around 70 percent of listed audit companies close their books in the end of March, and approximately 80 percent in terms of market capitalization. The result is that audit firms are busy providing audit services during a specific period of the year (Figure II-3-5, Figure II-3-6).

Figure II-3-5: Number of listed audited companies by ending fiscal period



March	2,433
December	388
February	211
Other	620
Total	3,652

Figure II-3-6: Market capitalization of listed audited companies by ending fiscal period



March	4,723,298
December	684,567
February	204,196
Other	300,984
Total	5,913,045

Source: Securities exchanges (as of March 2017)

2. Companies Adopting IFRS

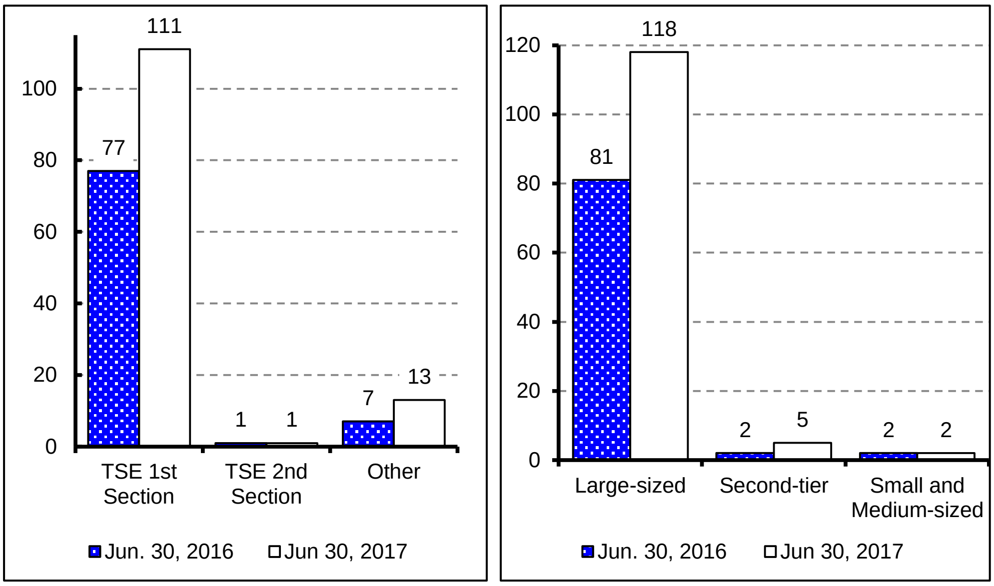
The following figures show which market companies voluntarily adopted IFRS and companies that plan to adopt IFRS are listed as well as which types of audit firms audit them. A great part of the companies adopting IFRS are listed on the First Section of the Tokyo Stock Exchange, and predominantly audited by large-sized audit firms. The same is also applicable to companies that are planning to voluntarily apply IFRS (Figure II-3-7, Figure II-3-8).

It is considered that almost all those companies operate overseas, and tend to choose large-sized audit firms, which are connected to the Big Four accounting firms.

Figure II-3-7: Companies voluntarily adopting IFRS (unit: number of companies)

By market

By type of audit firm

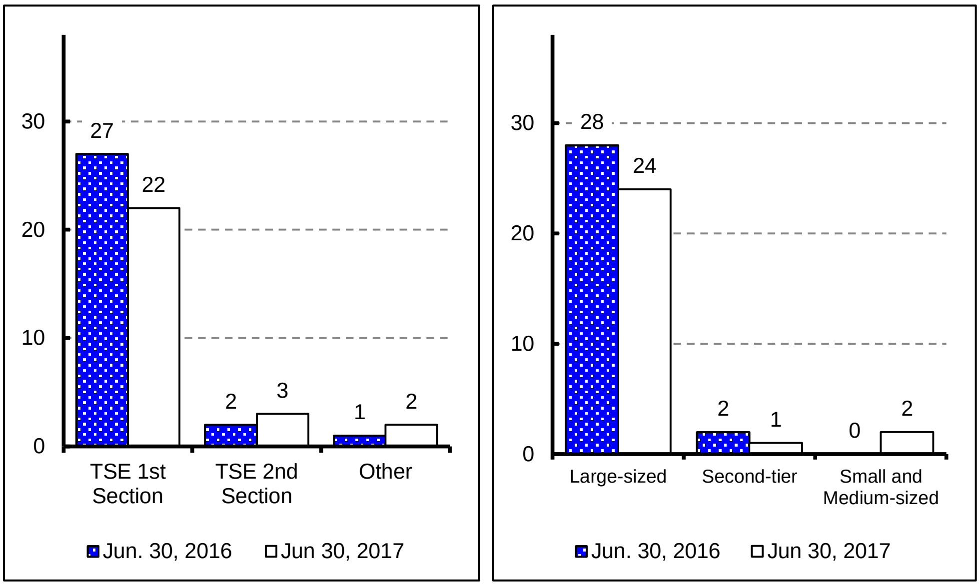


Source: Securities exchanges

Figure II-3-8: Companies planning to voluntarily adopt IFRS (unit: number of companies)

By market

By type of audit firm



Source: Securities exchanges

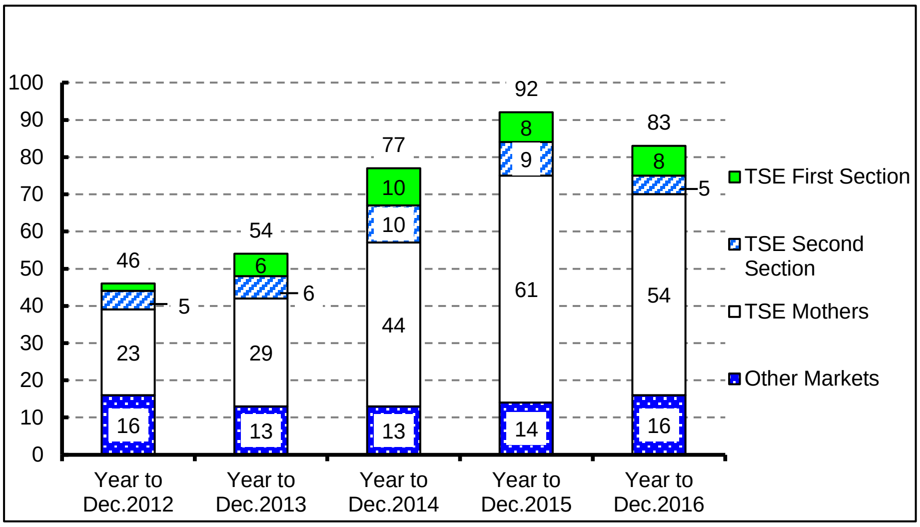
3. Audits of Initial Public Offerings

The number of IPOs increased every year until the year to December 2015, but has begun to decline in the year to December 2016. The figure for the year to December 2016 remains high when looked at from the perspective of the past five years.

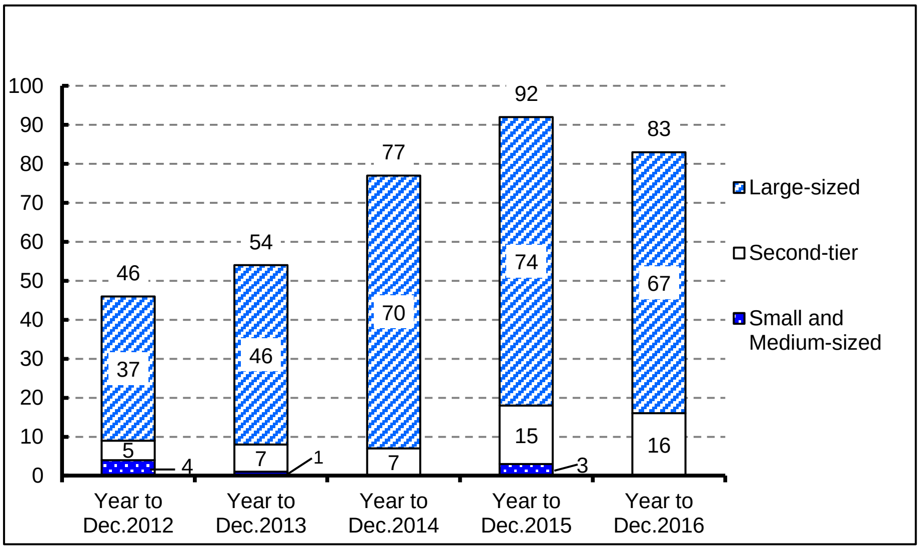
Regarding the share held by each type of audit firm, large-sized audit firms still possess the largest share, but the share held by large-sized audit firms dropped while that held by second-tier audit firms increased in the year to December 2016 (Figure II-3-9).

Figure II-3-9: Change in the number of IPOs (unit: number of companies)

By market



By type of audit firm at the time of listing



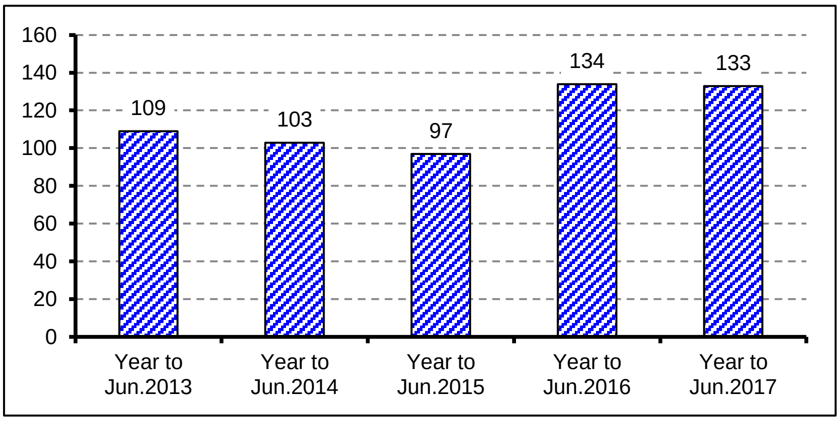
Source: Securities exchanges

D. Changes in Accounting Auditors

The number of domestic listed companies that changed their audit firm increased from 97 in the preceding term to 134 in the year to June 2016, and at 133 companies the figure remained high in the year to June 2017 (Figure II-4-1).

Among the above changes, there is a tendency to switch from large-sized audit firms to second-tier audit firms or small and medium-sized audit firms between years to June 2016 and 2017 from observation of the net change based on size of audit firm. (Figure II-4-2. For information on the reasons for changes, see III. Operation of Audit Firms, C. Acceptance of New Audit Engagements and Changes in Auditors, 2. Reasons for Changes in Auditors).

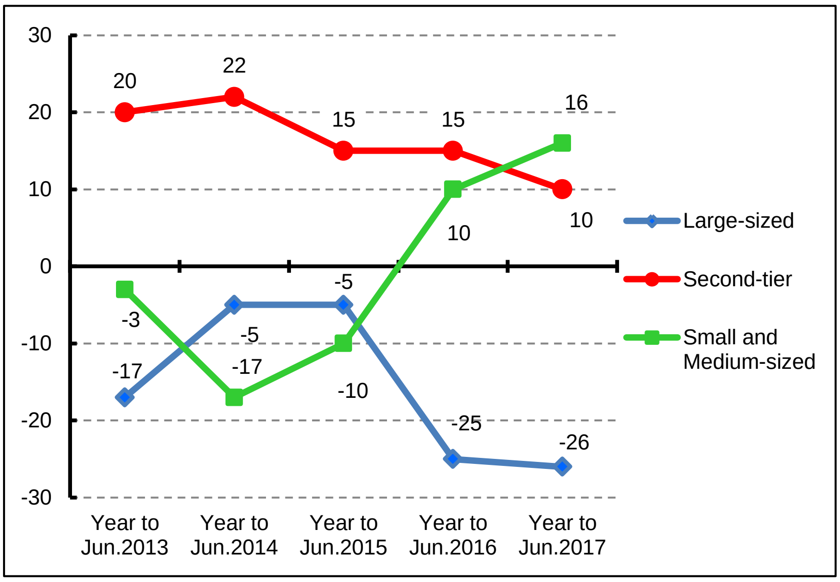
Figure II-4-1: Changes in the number of domestic listed companies changing their audit firm (unit: number of changes)



Note: Figures are for the number of companies that completed switching their audit firm by the end of June in each year.

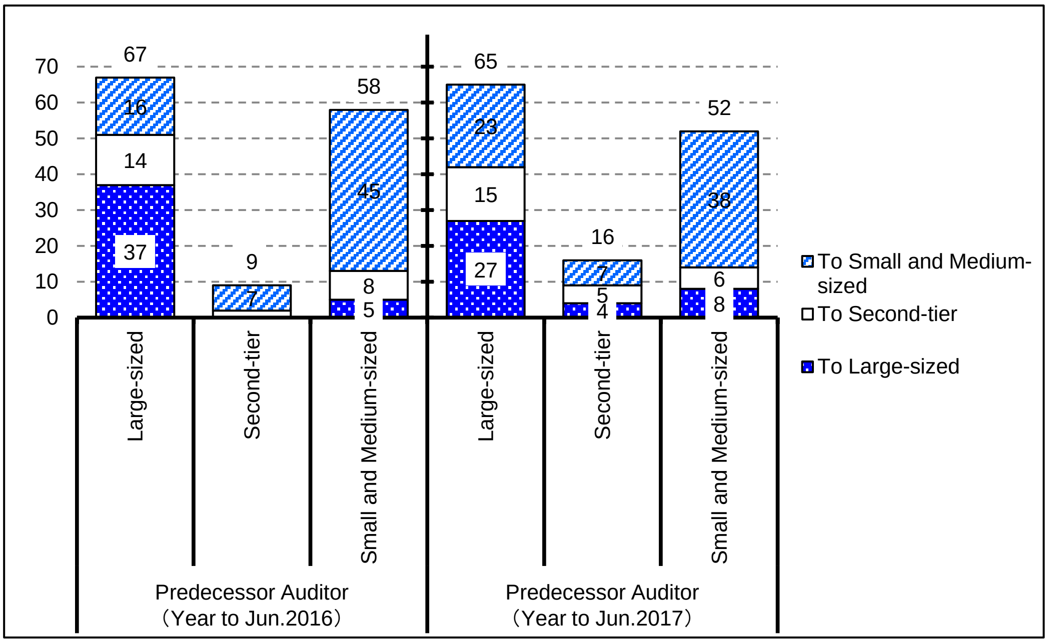
Figure II-4-2: Changes in audit firms by size (unit: number of changes)

(Net change in each type of audit firm)



Note: Figures are net changes.

Changes in auditors (year to June 2016, year to June 2017)



Source: Timely disclosure concerning changes of auditors

III. Operation of Audit Firms

III. Operation of Audit Firms

Audit firms that provide audit and attestation services comprise incorporated audit firms (audit firms), partnerships, and individual firms, and 2,047 firms were offering audit and attestation services in fiscal year 2015. Audit and attestation services for listed companies are mainly provided by audit firms, and there were 222 such firms as of March 31, 2017.

In recent years, there has been an increase in the number of articles in newspapers, magazines, etc., concerning audits and the role of audit firms. In contrast, people are generally unfamiliar with and have little understanding about audit firms. This is partly because the services they provide are highly specialized and their organizational structure is unique.

Audit firms range in size from ones with just five partners, the minimum number required by law, to ones with hundreds of partners and thousands of CPAs. Large-sized audit firms, in particular, have been expanding their capacity during the past several years, therefore, it is not easy for them to ensure that the policies and procedures for appropriate audit quality are being properly followed on the frontline of the organizations. As a result, they are continually reviewing and changing their approach to operations management environment.

The CPAAOB gathers and organizes information on operation of audit firms that it has obtained through its monitoring activities, and believes that the information should be made available to the general public.

A. Operations Management Environment

It is important that the measures they design to ensure proper service provision (operations management environment) reflect the size and characteristics of the audit firm concerned because audit firms are responsible for maintenance and improvement of their audit quality.

Because of this, the CPAAOB examines operations management environment, including quality control environment, at audit firms through its monitoring activities including inspections.

In this section, we will introduce the organizational structure of audit firms, describe their partners and personnel, and explain the environments that support the provision of audit services. We will also look at domestic audit networks and ties to global audit networks, particularly large-sized audit firms.

1. Organizational Structure of Audit Firms (Including Governance)

The characteristics of the organizational structure of each type of audit firm, as categorized by size, are shown below (Figure III-1-1).

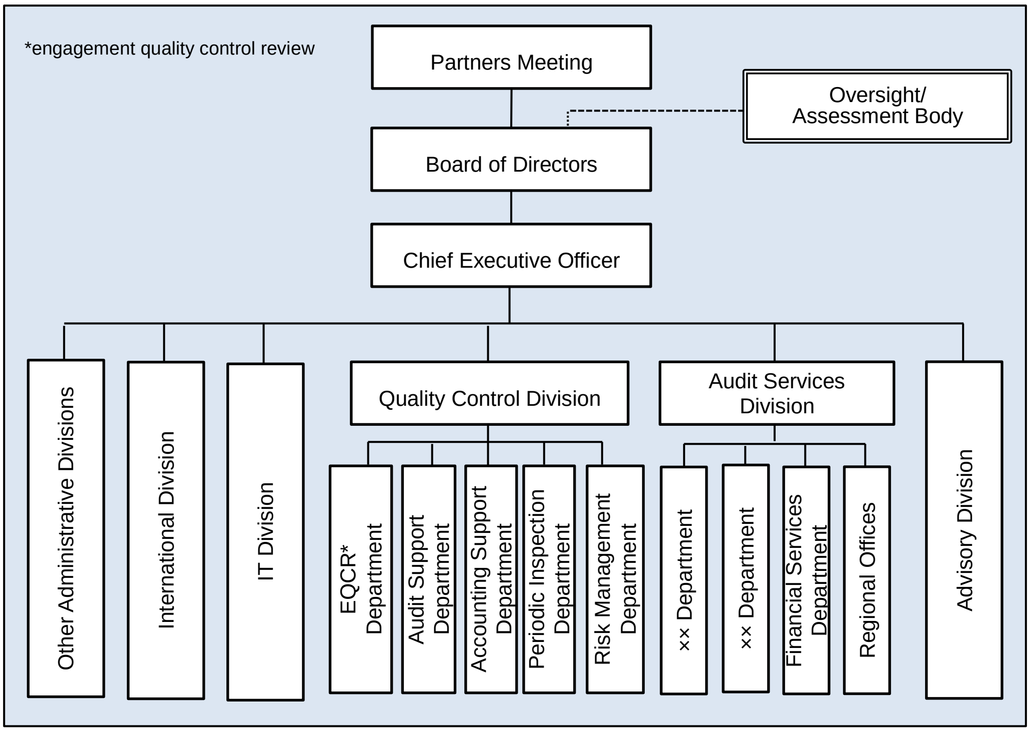
At large-sized audit firms, the highest decision-making body is the partners meeting, under which a board of directors is situated to make important decisions. The audit services division is divided into several departments that serve different regions or handle different services. There is also the quality control division that supports audit services and the system of large audit firms is more organized than that seen at small and medium-sized audit firms.

Small and medium-sized audit firms, on the other hand, have a smaller headcount, therefore, in many cases, the partners meeting also handles day-to-day decision making and the audit services division is not subdivided. Quality control tends to be handled by a particular partner, rather than a department being established for that purpose, thus the system is dependent more on individual expertise than that of large-sized audit firms.

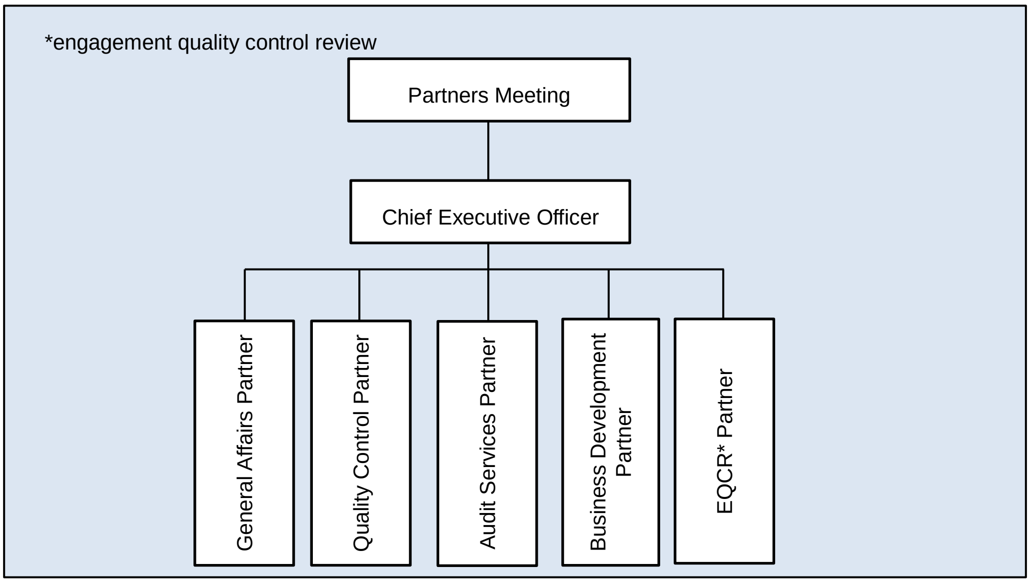
Furthermore, in response to the Audit Firm Governance Code, large-sized audit firms have installed oversight/assessment bodies that are independent of the firm's management. These bodies monitor and assess the effectiveness of management functions and thereby help make management more effective. These bodies are made up of independent third parties.

Figure III-1-1: Example of the organizational structure of audit firms

(Large-sized and second-tier audit firms)



(Small and medium-sized audit firms)



Characteristics of each type of audit firm identified through inspections are as follows (Figure III-1-2):

Figure III-1-2: Characteristics of each type of audit firm

	Large-sized	Second-tier	Small and medium-sized
Staff size:			
No. of partners	Between 100 and 600	Between 20 and 100	Fewer than 30
No. of full-time personnel	Approx. 2,000 to 6,000	Approx. 100 to 300	Up to 50
Organization:			
Decision-making body	·Highest decision-making body is the partners meeting ·Under the partners meeting, a board of directors and an executive committee are situated	·Highest decision-making body is the partners meeting ·Under the partners meeting, a board of directors is situated	·Most decisions are made at the partners meeting ·At larger firms, a board of directors is situated under the partners meeting
Design of business operation departments	·Several audit departments are established, and operation is also conducted by regional offices ·A department specializing in financial service is situated ·Departments in charge of quality control, risk management, etc., are situated	·Several audit departments are situated ·A department in charge of quality control is situated	·Usually, partners are appointed to handle main services without establishing particular departments ·Larger firm's organizational structure is similar to those found at second-tier audit firms.
No. of offices	·There are offices in metropolises (Tokyo, Osaka, and Nagoya) and often also local offices throughout the country	·Besides the firm's main office, there are often also offices in the metropolises	·Firms usually only have their main offices and do not have branch offices
Design of quality control divisions	·A quality control division comprises various departments for functions such as revising and distributing audit manuals, providing advice on accounting treatment, providing advice on IFRS or U.S. GAAP, engagement quality control review, and conducting periodic	·A quality control division comprises similar departments to those found at large-sized audit firms ·Some firms also have a department of engagement quality control review	·Usually, partners are appointed to handle quality control without establishing particular departments · ·A representative is sometimes also in charge of quality control

	Large-sized	Second-tier	Small and medium-sized
	inspections ·In a quality control division, a risk management department is situated for risk management of monitoring audit contracts, independence, and audit risk ·Audit services departments also often have quality control functions		

■Audit Firm Governance Code■

With public confidence in audit being called into question once again following recent accounting scandals, in October 2015, the Advisory Council on the Systems of Accounting and Auditing was established to deliberate a range of issues concerning the future of audits.

Under the circumstances that corporate activities, particularly those of large listed companies, become more complex and internationalized, the Council proposed strengthening the management of audit firms in light that the level of management by senior executives of large-sized audit firms does not completely meet the expansion of audit firms and the increasingly complex nature of organizational administration. In response to this proposal, the FSA issued “Principles for Effective Management of Audit Firms” (the Audit Firm Governance Code) on March 31, 2017. The Code is aimed at ensuring effective governance by clearly defining authority and responsibility for audit firm operation, and enabling management to function effectively throughout an organization.

The Audit Firm Governance Code is designed to ensure the roles that audit firms are expected to play, their organizational structure, their approach to business operation and transparency. It was primarily prepared with the organizational operation at large-sized audit firms and comprises five principles and 22 guidelines for the proper implementation of the principles. As of May 31, 2017, other than large-sized and second-tier audit firms, the Code has been also officially announced by small and medium-sized audit firms, Kagayaki, Seiyo and Hibiki.

2. Partners and Personnel

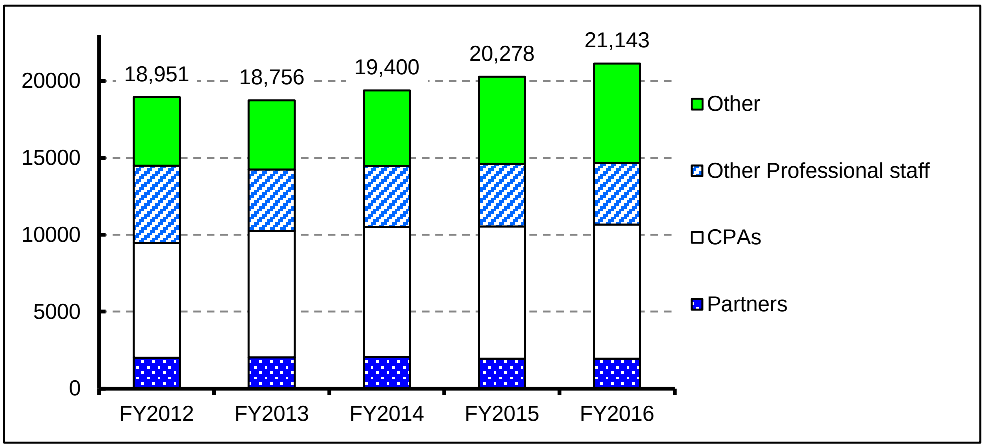
a. Partners and full-time personnel

A look at changes in the number of personnel at different types of audit firms reveals that while there was a decline at large-sized audit firms in fiscal year 2013, the headcount has been increasing since then. At second-tier audit firms, meanwhile, the number of personnel has been growing since 2012. At small and medium-sized audit firms, however, the headcount rose in 2012 but has been falling since then.

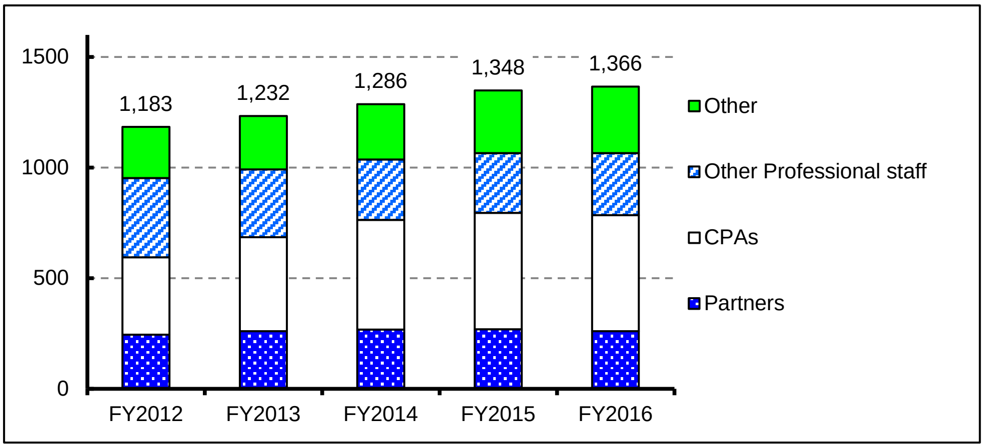
Looking at the composition of personnel at different types of audit firms, we see that the ratio of partner to the entire personnel is higher at the smaller firms. At second-tier audit firms, the average staff to partner ratio is approximately 19 percent, but at some of these firms, 40 percent of personnel are partners (Figure III-1-3).

Figure III-1-3: Change in the number of partners and full-time personnel (unit: number of persons)

<Large-sized audit firms (total of four audit firms)>

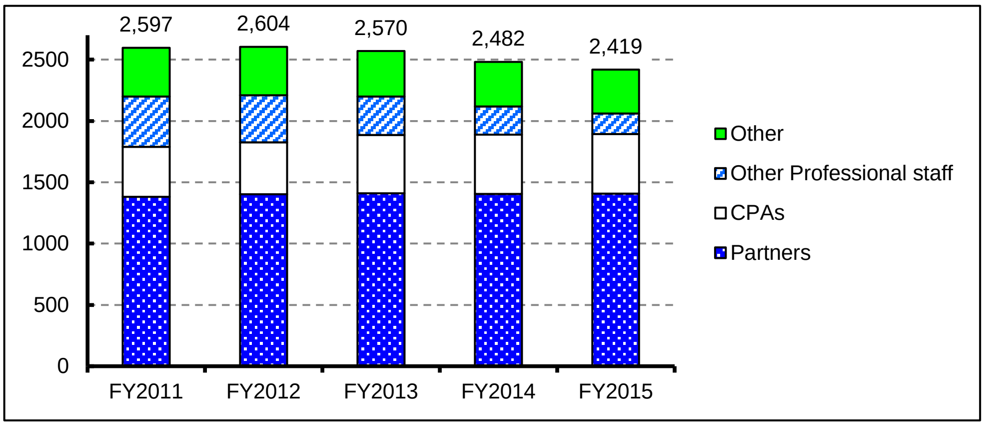


<Second-tier audit firms (total of six audit firms)>



Note: In FY2016, one audit firm changed its fiscal term, so the number of personnel at this firm in FY2016 cannot be determined. For this reason, we use the number of personnel at the firm in FY2015 instead of that in FY2016.

<Small and medium-sized audit firms (total)>



Note: The number of personnel at each fiscal year is the aggregated sum of all small and medium-sized audit firms. Regarding large-sized and second-tier audit firms, the data is available between FY 2012 and FY2016. Regarding small and medium-sized audit firms, the data is available between FY2011 and FY2015.

b. Partner's concurrent business

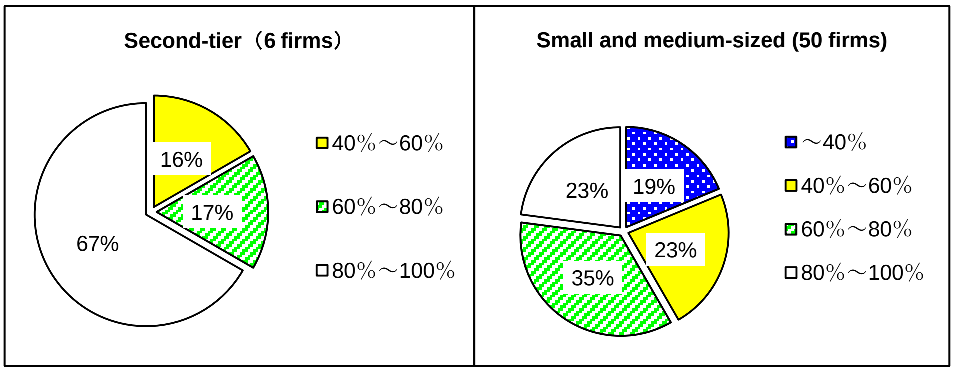
Large-sized audit firms generally do not allow partners to run their own individual firms, etc.

At second-tier audit firms, partner's side business is normally not permitted. Some firms allow it, and at some of these, more than 90 percent of partners run a side business.

At small and medium-sized audit firms, many partners already operate their own tax accountant offices before joining a firm, therefore, almost all small and medium-sized audit firms allow partners to run a side business.

The proportion of partners holding other positions tends to be low at some larger firms among small and medium-sized audit firms. It is thought that partners are increasingly specializing in the provision of audit services (Figure III-1-4).

Figure III-1-4: Average proportion of time that partners spend for their audit firms



Note: Prepared by the CPAAOB based on personal declarations made by partners on the proportion of their working time at their audit firms. These declarations were obtained during inspections and through the collection of reports in program year 2016.

c. Part-time personnel

Almost all personnel are full-time workers and the percentage of part-time personnel is extremely small at large-sized audit firms.

At second-tier audit firms, part-time personnel makes up around 20 percent of the headcount, on average. However, there are some second-tier audit firms where over 50 percent of personnel is part time.

At small and medium-sized audit firms, more than 50 percent of personnel is part time, and these firms depend on part-timers as partners or professional staff who work with engagement partners and are necessary for audit services (Figure III-1-5). However, the proportion of part-time personnel is less than 50 percent at small and medium-sized audit firms with ten or more full-time personnel (Figure III-1-6).

Figure III-1-5: Number of full-time and part-time personnel (FY2015, unit: persons)

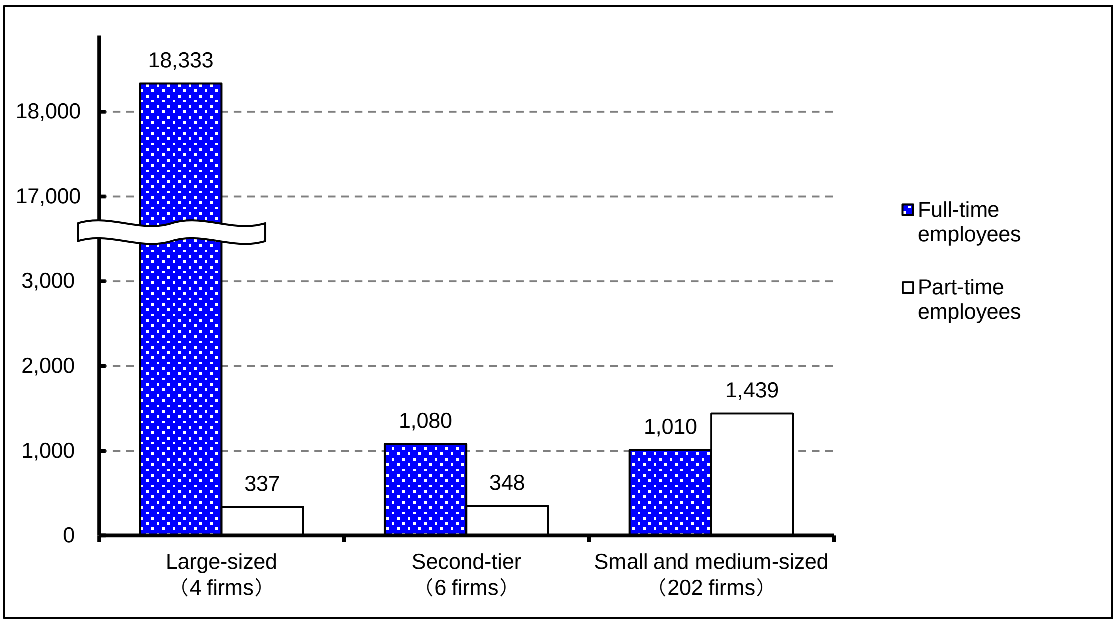
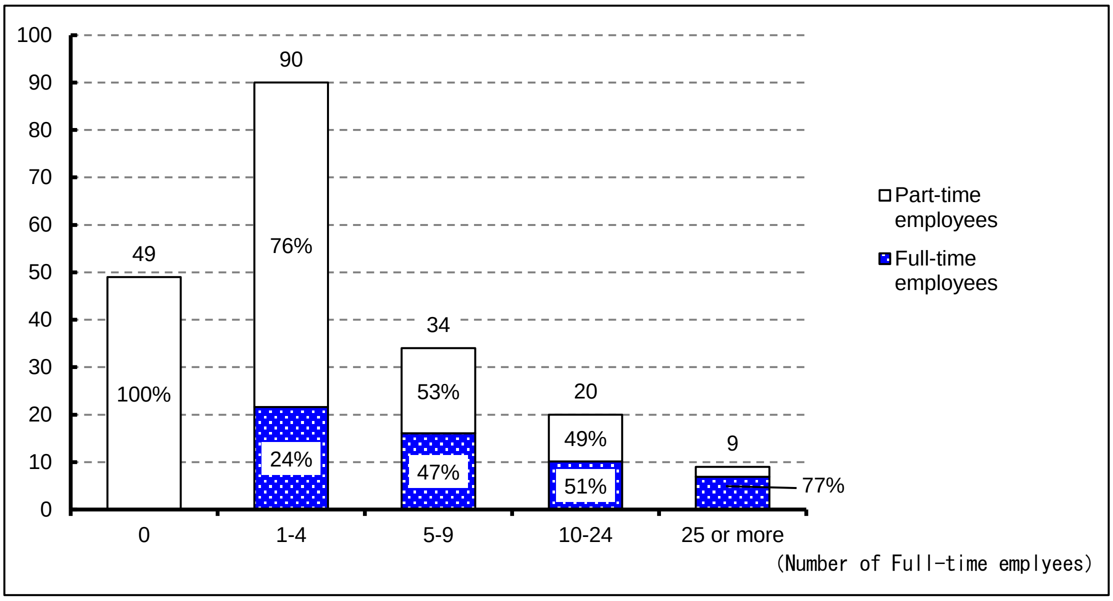


Figure III-1-6: Personnel composition at small and medium-sized audit firms by size (unit: number of firms)



Note: Data from 202 firms. Firms were classified by the number of full-time personnel. The number of personnel was totaled and the proportion of full-time and part-time personnel was calculated.

3. Environment for Supporting Audit Services

With audited companies becoming larger and more internationalized, it is essential for audit firms to support, such as provision of expertise, engagement teams to ensure an appropriate audit. This is a particularly important issue at large-sized audit firms, which audit a lot of large companies with overseas operations.

Because of this, the CPAAOB monitoring focuses not only on individual audit engagements, but also on whether audit firms take the measures for ensuring the appropriateness of audit services (environment for supporting audit services) tailored to the firm's scale and characteristics.

In this section we will provide an overview of environment for supporting audit services that we have found through our monitoring activities. We will also provide some examples, mainly from large-sized audit firms, of environment for identifying audit-related risks and the utilization of IT systems to support individual audit engagements.

Note that the Audit Firm Governance Code defines the following as important measures for ensuring audit quality, and firms adopting the Code are required to institute them: development of organizational structure to ensure appropriate judgments of the audit firm, establishment of environment for identifying audit-related risks, and the consideration and development of the effective utilization of IT in order to enhance the efficiency and effectiveness of audits (Audit Firm Governance Code, Guidance 2-2).

a. Overview of environment for support

To ensure appropriateness of services, large-sized audit firms have situated various departments covering such functions as risk management, periodic investigations, accounting support, audit support, engagement quality control review, IT, and international services (Figure III-1-7). See "F. Engagement Quality Control Review" and "G. Monitoring in System of Quality Control" later in this report for information on the situation with engagement quality control review and periodic inspections.

Figure III-1-7: Examples of support systems at large-sized audit firms

Support departments		Role
Quality control division	Risk management department	Ensuring independence, approving acceptance of and withdrawal from audit engagements, etc., responding to risk of fraud, etc.
	Periodic inspection department	Ongoing monitoring and periodic inspections
	Accounting support department	Responding with expert advice to inquiries concerning accounting standards and treatment etc.
	Audit support department	Responding with expert advice to inquiries concerning audit standards, manuals, and procedures
	Engagement quality control review department	Even though engagement quality control reviews are conducted by engagement quality control reviewers, this department performs higher-level engagement quality control reviews of individual matters that are of high importance or are high risk
IT division		Conducting IT audits for audited companies, supporting audit procedures involving the utilization of IT conducted by engagement teams, etc.
International division		International business audits, group audits

There are more than 100 full-time professionals on average at the quality control divisions of large-sized audit firms according to our collection of reports and on-site inspections. These professionals work with personnel in charge of quality control in the audit services division.

Many second-tier audit firms also have the quality control divisions, but their structure is smaller than those of large-sized audit firms. Small and medium-sized audit firms, on the other hand, sometimes do not have a quality control division. Instead, they have a person in charge of quality control, and sometimes this person is the firm's representative.

b. Management of risk information

To handle high-risk audit engagements and to respond to risk of fraud, audit firms develop and operate an environment for the cross-organizational management of risk information.

Specifically, large-sized audit firms handle it as follows (Figure III-1-8):

Figure III-1-8: Management of risk information at large-sized audit firms

Actions taken by risk management department: • Developing a database of past fraud cases in order to share information on them within an audit firm • Selecting high-risk audit engagements and monitoring and providing support to engagement teams by gathering information during the audit period • Maintaining a system for acquiring expertise from inside and outside of an audit firm and performing a high-level engagement quality control review when there are circumstances that indicate the possibility of a material misstatement due to fraud or suspicion of a material misstatement due to fraud • Organizing a team of experts for investigating fraud within an audit firm or its group companies • Establishing and operating a desk for receiving reports from whistleblowers inside or outside an audit firm and an internal reporting system and a hotline Actions taken by engagement teams: • Addressing risk of fraud through the use of data analysis tools • Seeking expertise from the quality control department when addressing risk of fraud or considering high-risk matters and taking higher-level engagement quality control reviews

c. Utilization of IT

Large-sized audit firms have situated specialized units of IT to serve as internal specialists to deal with the increasingly complex information systems deployed by audited companies. They are also continuously investing in IT for utilization in auditing (Figure III-1-9).

Figure III-1-9: Utilization of IT in audit services at large-sized audit firms

Status	Technology
Installed	･ Electronic audit documentation system (electronic preparation and administration of audit documentation) ･ Audit-related software (sampling tools, etc.) ･ Audit monitoring system (management of audit time and profitability, etc.)
Plan to install (includes technologies already installed at some audit firms)	･ VDI (desktop virtualization) ･ Abnormality analysis by using journal record from audited companies ･ Fraud prediction models based on the risk analysis of publicly disclosed financial data ･ Use of IT for vouching (e.g., method for testing all sales data in an audited company with external data)
Under development	･ Use of big data and AI (artificial intelligence)

Furthermore, each large-sized audit firm is affiliated with one of the Big Four accounting firms, and they share audit tools including electronic audit documentation systems with them (See 5. Ties with Global Audit Networks for details.). In fiscal year 2016, each large-sized audit firm invested 1,448 million yen[9] on average in IT including payments to the Big Four accounting firms in relation to IT (1.8 percent of operating revenue).

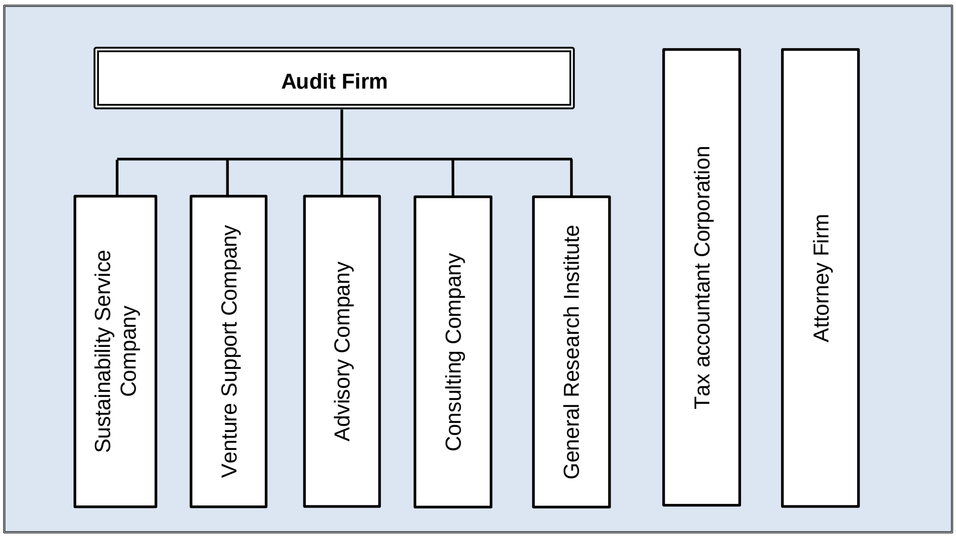
[9] Prepared based on self-declarations by audit firms of amounts of IT investment obtained during inspections and through the collection of reports.

4. Domestic Audit Network

Most of the large-sized audit firms and second-tier audit firms are members of their domestic network that use common logos and brands and cooperate with each other in the provision of services. Besides the audit firms, those networks generally include a tax accountant corporation, consulting companies that perform financial due diligence, valuation service of companies, investigate fraud, etc., and advisory companies that provide financial advice on M&A deals.

A typical group structure is where the audit firm takes direct equity stakes in the group firms (excluding tax accountant corporation and attorney firms (Figure III-1-10).

Figure III-1-10: Sample structure of a large-sized audit firm group



Note: Besides the above, some audit firms have established a holding partnership for managing their global brand and the group firms operate under this holding partnership.

The average number of domestic group companies in each network is 12 in large-sized audit firm's networks, while the number is six in second-tier audit firms[10].

Regarding domestic network operation, the network typically holds councils that comprise representatives from the major domestic group companies. This allows the group companies to coordinate their interests and discuss their joint businesses.

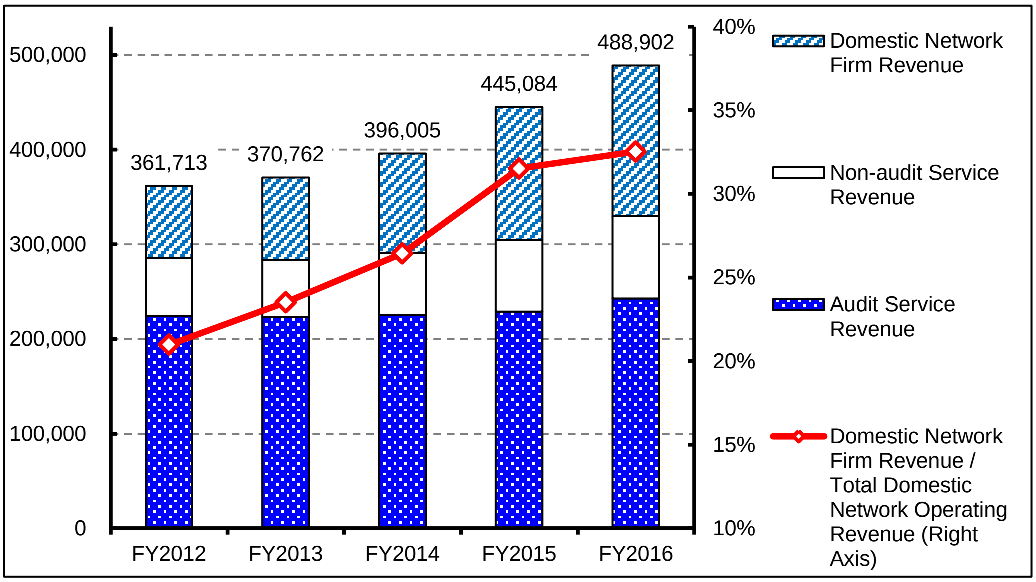
[10] Based on publicly disclosed materials from each audit firm.

A look at the changes in the proportion of total operating revenue[11] generated by group companies other than the audit firms reveals that at large-sized audit firms the operating revenue of the audit firms has been static, while that of group companies has been increasing, and that this trend has resulted in the proportion of operating revenue coming from group companies recently exceeding 30 percent. Furthermore, revenue from non-audit services (group companies revenue plus non-audit service revenue at audit firms) accounted for more than 50 percent of operating revenue for the domestic networks as a whole in fiscal year 2016.

At second-tier audit firms, on the other hand, revenue from domestic group companies other than the audit firm's accounts for a small percentage of total operating revenue, and the amount has not changed much. Domestic network revenue structure differs greatly depending on the size of the firm (Figure III-1-11).

Figure III-1-11: Changes in operating revenue of domestic networks and the percentage of operating revenue from domestic networks firm (unit: JPY 1 million (left axis))

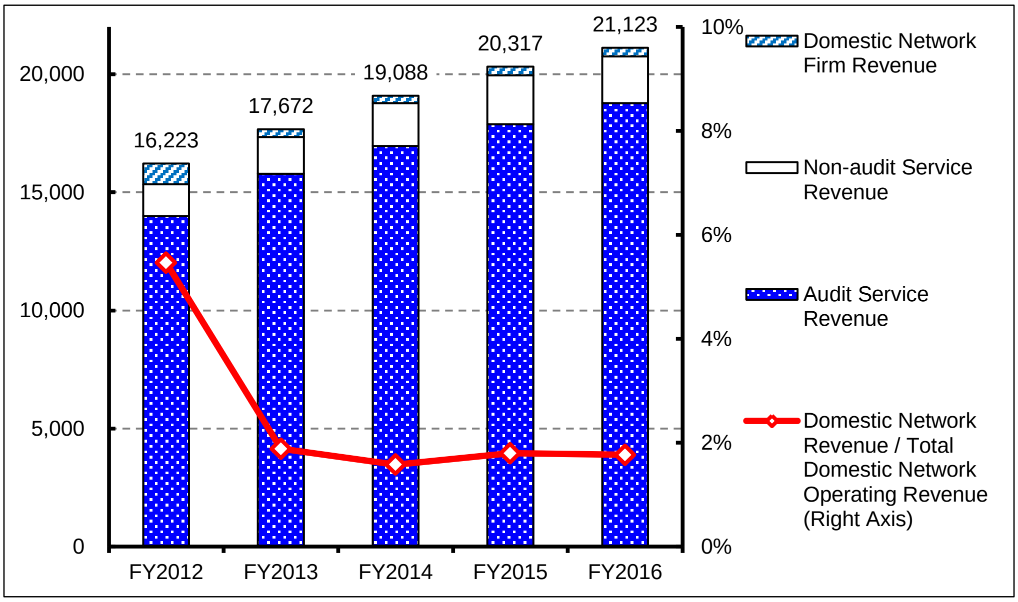
<Large-sized audit firms (total of four firms)>



Note: Operating revenue of domestic networks does not include operating revenue of tax accountant corporations and attorney firms.

[11] Excludes operating revenue of tax accountant corporations and attorney firms.

<Second-tier audit firms (total of six audit firms)>



Note 1: Operating revenues are the sum of each domestic network for the above fiscal years.

Note 2: In FY2012, we totaled one audit firm's revenue for only three months to total amount due to a change in the firm's fiscal term.

Note 3: In FY2016, the operating revenue of one audit firm in FY2016 cannot be determined due to a change in the firm's fiscal term. For this reason, we use the operating revenue of the firm in FY2015 instead of that in FY2016.

5. Ties with Global Audit Networks

Large-sized audit firms, second-tier audit firms, and some small and medium-sized audit firms belong to global audit networks. This makes it easier for them to perform audits of audited companies with overseas operations and enables them to share know-how such as audit manuals.

a. Membership of global audit networks

While all large-sized audit firms and second-tier audit firms belong to global audit networks, only some small and medium-sized audit firms do (Figure III-1-12, Figure III-1-13).

Figure III-1-12: The number of audit firms granted membership of global audit networks (FY2015)[12]

Large-sized audit firms	4
Second-tier audit firms	6
Small and medium-sized audit firms	22
Total	32

Figure III-1-13: List of global audit networks to which large-sized audit firms and second-tier audit firms belong

Audit firm	Global audit network
KPMG AZSA LLC	KPMG International Cooperative
Ernst & Young ShinNihon LLC	Ernst & Young Global Limited
Deloitte Touche Tohmatsu LLC	Deloitte Touche Tohmatsu Limited
PricewaterhouseCoopers Aarata LLC	PricewaterhouseCoopers International Limited
GYOSEI & CO.	NEXIA International Limited
BDO Sanyu & Co.	BDO International Limited
Grant Thornton Taiyo LLC	Grant Thornton International Limited
BDO Toyo & Co.	BDO International Limited
PricewaterhouseCoopers Kyoto	PricewaterhouseCoopers International Limited
YUSEI Audit & Co.	Crowe Horwath International

Source: Based on data from publicly disclosed materials from each audit firm (as of June 30, 2017)

12 Small and medium-sized audit firms that have established collaborative alliances with overseas audit firms are also counted as small and medium-sized audit firms which granted membership of global audit networks.

b. Relationships with global audit networks

Network firms comprising global audit networks are responsible for a range of areas including quality control, etc., while they can use the networks' logos and brand, introduce business to each other, and share know-how. The nature and degree of these responsibilities vary depending on the scale of the global audit network. In general, the larger the global audit network, the more influence it can exert on its members.

Each of the large-sized audit firms belongs to any of the Big Four accounting firms (Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers) and has established close relationships with them. Specifically, they not only have the right to use the networks' logos and brand, but are also involved in operation of the networks. For example, their CEOs are members of important network committees.

Large-sized audit firms have also received audit manuals and tools from the networks, and they carry out audits in accordance with the audit manuals that are based on the networks' standards. Moreover, they have adopted standards and procedures determined by the networks for engagement quality control reviews, independence, and other quality controls.

Large-sized audit firms also regularly have global reviews conducted by the networks in order to maintain audit quality, particularly for individual audit engagements, at the level required by the networks. Some firms regard the global reviews as all or part of the internal periodic inspection in relation to quality control (See III. Operation of Audit Firms, G. Monitoring in System of Quality Control, 2. Utilization of Global Reviews for details.).

All second-tier audit firms are affiliated with global audit networks. However, the extent of their ties differs depending on size of the networks. Some have formed alliances that are at the same level of those of the large-sized audit firms, while others maintain moderate ties, only having the right to use the networks' logos and brand and getting referral of audit engagements from network firms in other countries, but not receiving audit manuals. Although all the audit firms have global reviews, there are big differences in terms of the frequency and content of the reviews.

The networks to which small and medium-sized audit firms belong only allow them to use their logos and brand and to be introduced to audit engagements in network firms' countries. Some of the small and medium-sized audit firms do not receive audit manuals or have global reviews.

B. Education, Training, and Evaluation for Audit Firm Personnel

In order to maintain and improve quality of audit, audit firms need to provide their personnel with opportunities to acquire necessary expertise and also need to evaluate them appropriately. It is particularly important to cultivate and evaluate audit firm personnel who can exercise the proper professional skepticism needed to identify accounting fraud.

For these reasons, the CPAAOB places a high priority on hiring, training, assignment, and firm management including performance evaluation and compensation of audit firm personnel. The CPAAOB looks into these points through monitoring activities including inspections.

In this section we will describe audit firm's education, training, and evaluation of the audit firm personnel including engagement partners, which we have perceived through our monitoring activities.

1. Education and Training of Personnel

The quality control standards constitute that audit firms must determine policies and procedures for reasonably ensuring that they have sufficient personnel with the competence, capability, experience and commitment to ethics necessary to perform audits in conformance with professional standards. (QCSCS (28)).

To meet this requirement, audit firms have developed structures for educating and training their personnel in proportion to their size (Figure III-2-1).

Figure III-2-1: Examples of education and training structures

Large-sized, second-tier	• Establishing a training section within the human resources department. This section designs and operates training programs for each position and experience • Implementing a series of training courses including updates of the foreign and domestic accounting and auditing standards, utilizing audit tools, corresponding risk of fraud, the results of periodic inspections such as the CPAAOB inspections and the JICPA reviews • Conducting examination after training • Providing foreign language training held in Japan and overseas and offering aid for obtaining language qualifications to improve the language skills of partners and professional staff at some firms
Small and	• Providing opportunities to attend training sessions held at the JICPA headquarters or regional chapters, or to study by watching the JICPA

medium-sized	training DVDs in most firms • Sharing results of periodic inspections, the CPAAOB inspections, and the JICPA reviews within firms

Large-sized audit firms and second-tier audit firms have education and training sections. In addition, large-sized audit firms have developed training programs for different positions and experience in conjunction with their global audit networks.

On the other hand, some of small and medium-sized audit firms have difficulties on providing training programs that are suitable to personnel’s experience and capability and their audited companies due to lack of the human resources to provide their own educational and training programs. Therefore, they just have personnel watch DVDs supplied by the JICPA.

As the number of companies adopting IFRS exceeded one hundred in Japan, there has been an increasing number of partners and personnel involved in audits of audited companies which apply IFRS, especially at large-sized audit firms. For that reason, the CPAAOB monitors the training structures relating to IFRS (Figure III-2-2).

Figure III-2-2: Examples of education/training being provided to audit companies adopting IFRS

Large-sized, second-tier	• Introducing a firm specified IFRS certification, and providing periodic trainings on updates of the standards for certified personnel • Distributing necessary guidelines within a firm by the specialized sections, which is established to interpret IFRS and advise how to apply in audits • Dispatching personnel to or exchanging information with the organization responsible for interpreting IFRS and formulating policies for the application in their global audit network

2. Performance Evaluation of Personnel

Like education and training, the appropriate performance evaluation of the personnel is also important for improving audit quality at audit firms as a whole. It should be noted that performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles (including independence) (QCSCS A24).

a. Evaluation of partners

Performance evaluation of partners is conducted based on audit quality, contribution to audit firm operations, and the number of new contracts obtained. In recent years, performance evaluation procedures have been shifted to emphasize audit quality controls. For example, large-sized audit firms perform the evaluations as follows:

- Partners are usually evaluated in various areas, including team management and business development based on "the Performance Evaluation Rules." In the case of partners who provide audit services, there is an emphasis on quality control.
- An audit firm places a partner performance evaluation system that emphasizes audit quality, including communication with executives of audited companies.
- Skills and performance evaluations are conducted, and it places a high weight on "quality control" and "expertise/skills" at the skills evaluations.
- Assessments made during periodic inspections* influence the performance evaluation of partners (*See G. Monitoring in System of Quality Control, 1. Periodic Inspection).

The results of performance evaluation are provided to partners in the form of feedback, and the partners are usually expected to take necessary action, such as setting goals for addressing areas that need improvement. Some audit firms adjust partner compensation and assignment of audits based on evaluation. The firms occasionally restrict partners to be involved in audit engagements when evaluation results are extremely poor.

■Example of an Identified Deficiency in Partner Evaluation■

During an inspection of a second-tier audit firm, the CPAAOB found that audit quality was not improved because partners were unaware of their problems on audit quality. That was caused by the firm not conveying to the partners the quality control problems found through their evaluation.

b. Evaluation of personnel

Audit firms evaluate personnel in accordance with their evaluation standards and determine their treatments such as promotions based on the results of evaluation.

Large-sized audit firms and second-tier audit firms generally promote new hires to managerial positions after approximately 10 years and to partner after a further seven to ten years. Small and medium-sized audit firms, however, rarely hire new graduates, and sometimes they hire mid-career auditors based on the assumption that they will be promoted to partners.

Both large-sized audit firms and second-tier audit firms often evaluate personnel based on factors such as audit quality, understanding of auditing standards and communication within engagement teams. Small and medium-sized audit firms conduct a similar evaluation, but have often not established a policy of giving promotions to partner or other positions on evaluation results.

■Example of an Identified Deficiency in Evaluation of Personnel■

During an inspection of a second-tier audit firm, it was found that evaluation results to part-time personnel were not being adequately taken into account determining promotions, demotions, and the composition of engagement teams even though part-time personnel engaged in audit was evaluated in the same way as full-time personnel. This was because the firm was afraid of part-time personnel resignations when they were treated harshly and it could interfere with the smooth provision of audit services.

C. Acceptance of New Audit Engagements and Changes of Auditors

In II. Overview of the Audit Sector, D. Changes in Accounting Auditors, we analyzed changes of auditors in listed companies based on size of audit firm. Particularly, the acceptance of new audit engagements has a significant impact not only on the quality level of individual audit engagements but also on the operation of the audit firm. The CPAAOB have also collected information and conducted examinations on this matter through our monitoring activities, which include inspections.

In this section, we will analyze the acceptance of new audit engagements and changes in auditors using information obtained through monitoring activities. We will also analyze the relationship between the information which was collected through monitoring activities and publicly disclosed information.

1. Acceptance of New Audit Engagements

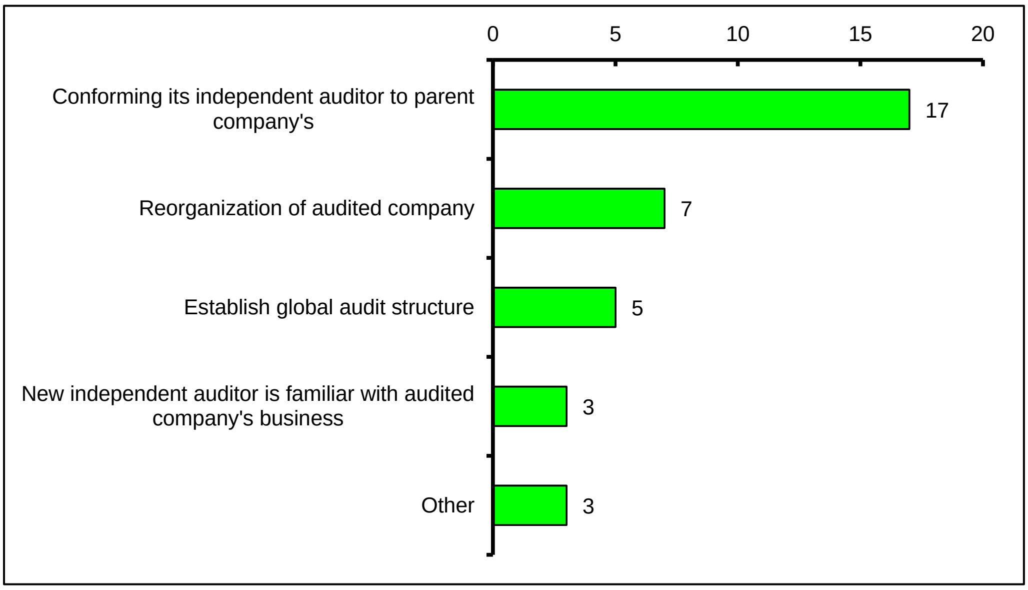
a. Large-sized audit firms

Because large-sized audit firms also provide non-audit services to companies other than their audited companies, they can get a request to audit these companies through deepening their relationship with the companies by the provision of non-audit services. Furthermore, audited companies can request some audit firms to submit proposals and can have a competition when accepting new audit engagements. In such cases, audit firms take integrated organizational efforts, for example, partners who are familiar with the sector in which audited companies operate are assigned to work on the proposals.

Our inspections of large-sized audit firms and our collection of reports allowed us to identify the reasons for the conclusion of 32 audit contracts. Main reasons were to assign the same auditor with the parent company or the reorganization of audited companies (Figure III-3-1).

Figure III-3-1: Large-sized audit firms - Reasons for acceptance of new contracts with independent auditors by domestic listed companies (unit: number of contracts)

<Large-sized audit firms (total of four audit firms)>



Note 1: Based on data from the 32 out of 65 contracts identified through inspections and report collection during program year 2016 where the reason for selections is described.

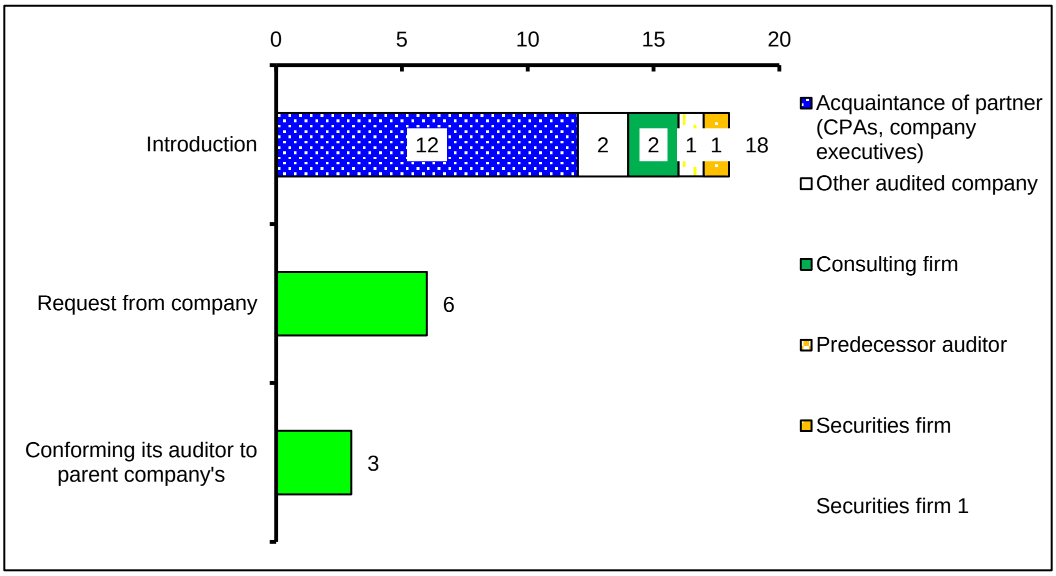
Note 2: If there was more than one reason, that contract is included in the figure for each reason (a cumulative total of 35).

b. Second-tier audit firms and small and medium-sized audit firms

The most common reason for both types of firms was an introduction from an acquaintance of partners among 27 audited companies, which made new audit engagements with second-tier and small and medium-sized audit firms between July 2015 and June 2016, according to information obtained from inspection and collection of reports. It seems that second-tier and small and medium-sized audit firms tend to accept audit engagements through the personal connections of partners. (Figure III-3-2).

Figure III-3-2: Firms other than large-sized audit firms - Reasons for acceptance of new contracts with independent auditors by domestic listed companies (unit: number of contracts)

<Second-tier audit firms and small and medium-sized audit firms>



Note: Based on reports from second-tier audit firms (six firms) and small and medium-sized audit firms (49 firms, 32 individual firms).

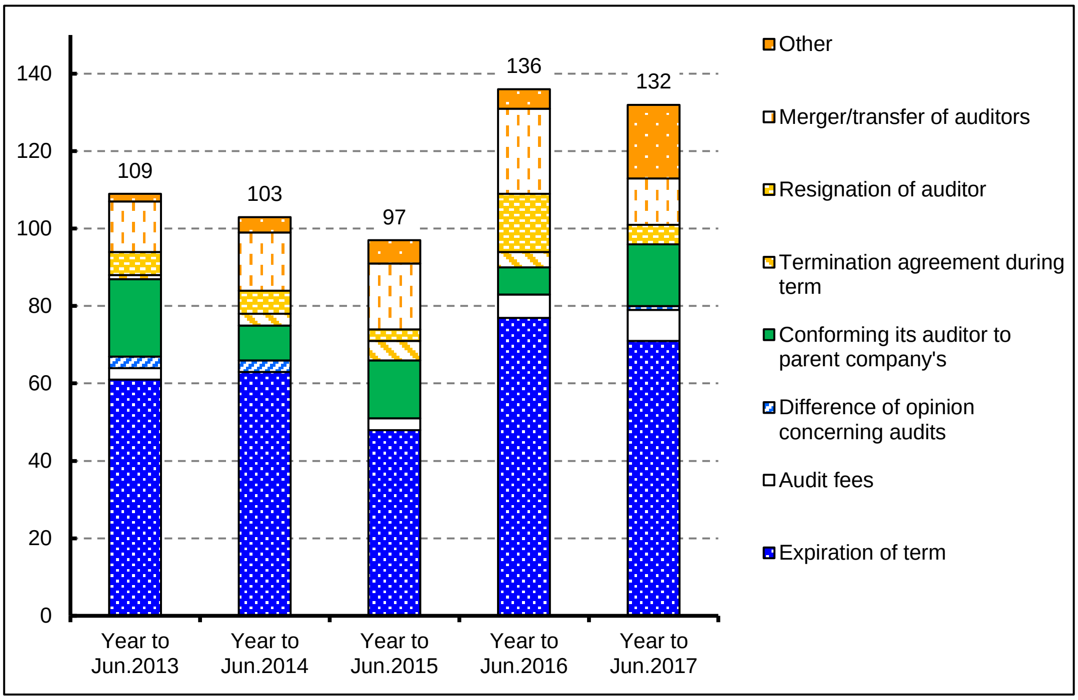
2. Reasons for Changes in Auditors

a. Reasons for changes in auditors given in timely disclosures by audited companies

When a listed company has changed its auditors, the listed company must disclose details immediately and the reason for it (Article 402 of the Securities Listing Regulations, Tokyo Stock Exchange).

The most common reason for the changes given was the expiration of the audit term, with substantial reasons not being given in many cases and other frequently seen reasons were the parent company and its subsidiaries to use the same auditor and the merger/transfer of auditors, according to disclosures made in accordance with the Securities Listing Regulations during the past five years (Figure III-3-3).

Figure III-3-3: Reasons for changes in auditors by domestic listed companies (unit number of cases)



Source: Timely disclosure concerning changes in auditors

b. Reasons for changes in auditors as identified through monitoring activities

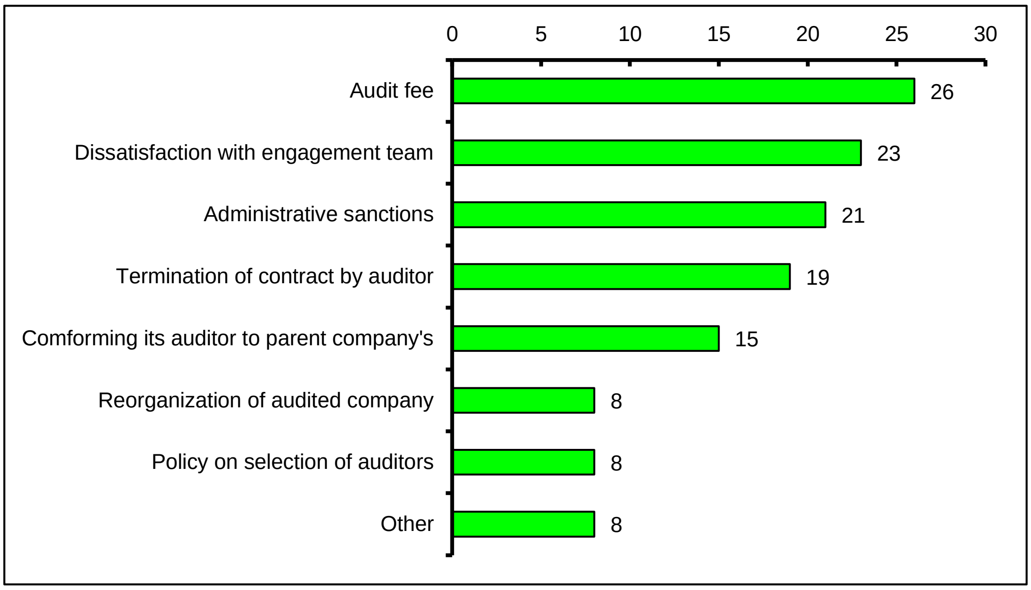
(1) Large-sized audit firms

Predecessor auditors pointed out audit fees and dissatisfaction with the audit engagement team as the primary reasons for the changes, with each of them accounting for around 20 percent, according to the result of inspections and collection of reports.

Dissatisfaction with the audit engagement team included the auditor’s response to fraud and prior period adjustment, differences of opinion on accounting interpretation, and dissatisfaction in the communication with the audit engagement team (Figure III-3-4).

Figure III-3-4: Large-sized audit firms - Reasons for changes in auditors according to the predecessor auditors (unit: number of changes)

<Large-sized audit firms (total of four audit firms)>



Note 1: Based on data from 97 changes identified through inspections and report collection during program year 2016.

Note 2: If there was more than one reason, that change is included in the figure for each reason (a cumulative total of 128).

<Comparison between reasons disclosed in timely disclosures and reasons identified through monitoring activities>

We compared the cases where the predecessor auditor had given the reason for the change of auditors as audit fees or dissatisfaction with the engagement team with those given in timely disclosures submitted by audited companies.

While audited companies explained expiration of the term as the reason for the change in their timely disclosure statements, we revealed 19 of those 26 cases in which audit fees were given as the reason and 17 of those 23 cases in which dissatisfaction with the engagement team were given as the reason through inspection of predecessor auditors (Figure III-3-5).

Figure III-3-5: Comparison of reasons for changes in auditors (unit: number of changes)

Reason given in entity's timely disclosures / Reason identified through monitoring activities	Expiration of term	Audit fees	Comforming its independent auditor to parent company's	Difference of opinion concerning audits	Other	Total
Audit fees	19	3	2	0	2	26
Dissatisfaction with engagement team	17	2	2	1	1	23

Note: We compared dissatisfaction with audit fees (26 changes) and dissatisfaction with the engagement team (23 changes) as reasons for changes in auditors identified through monitoring of the predecessor auditors in program year 2016 with the reasons given by audited companies in timely disclosures.

Sources: the CPAAOB and timely disclosures

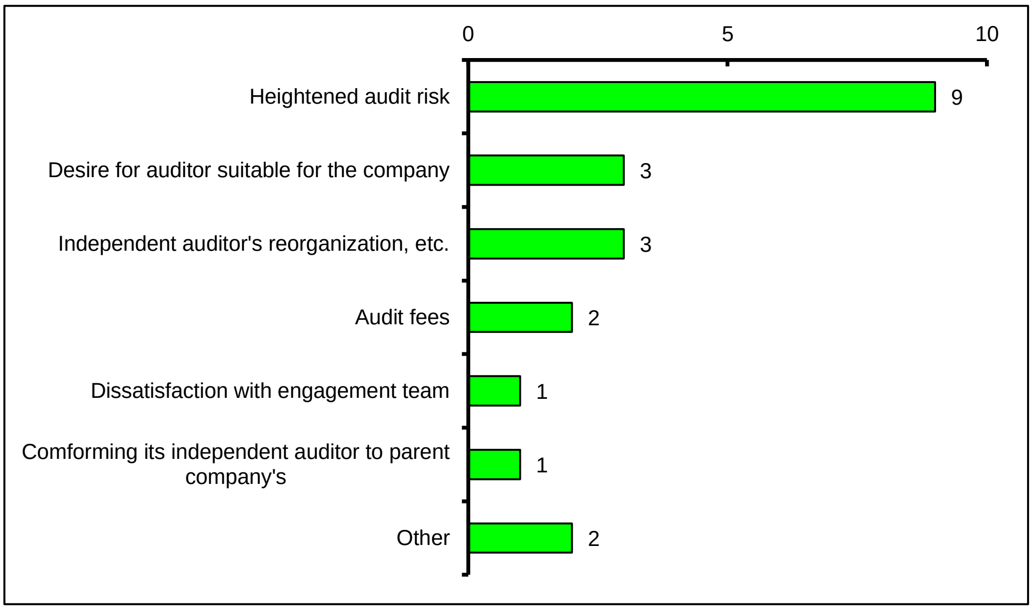
(2) Second-tier audit firms and small and medium-size audit firms

Among 21 changes of auditors occurring between July 2015 to June 2016, half of the cases were that predecessor auditors decided not to continue audit contracts due to heightened audit risk as a result of an expansion in the scope of operation of audited companies, changes in shareholders, related-party transactions, etc., according to the information obtained by the predecessor auditors through inspections of and the collection of reports from second-tier and small and medium-sized audit firms. Besides, the CPAAOB observed some other reasons for changes were that the audited companies prefer auditors commensurate with their capacities and they reorganized their companies. (Figure III-3-6).

With regard to seven out of the nine cases, where auditors did not renew audit engagements due to heightened audit risk, audited companies described their expiration of the audit term in their timely-disclosure.

Figure III-3-6: Firms other than large-sized audit firms - Reasons for changes in auditors according to the predecessor auditors (unit: number of changes)

<Second-tier audit firms and small and medium-sized audit firms>



Note: Based on reports from second-tier audit firms (6 firms) and small and medium-sized audit firms (49 firms, 32 individual firms).

D. Audit Fees

1. Rules on Audit Fees

Audit fees are determined through negotiations between the parties to the audit contract. The JICPA has set guidelines for the calculation of audit fees to serve as a reference when determining them.

On the other hand, the JICPA's Code of Ethics stipulates that the audit firms should consider the application of safeguards in the case of low fees. This is on the background that it is appropriate to charge the audit fees based on the nature or value of the services provided, whereas offering or charging low fees without reasonable grounds could make it difficult to provide a certain level of professional services.

2. Methods of Calculating Audit Fees

The JICPA's "Guidelines for the Calculation of Audit Fees" give "hourly rates" and "fixed fees and hourly rates" as possible approaches. These methods are used when calculating estimated standard fees, with the final audit fee being determined through negotiations with audited companies (Figure III-4-1).

Figure III-4-1: Methods for calculating audit fee estimates

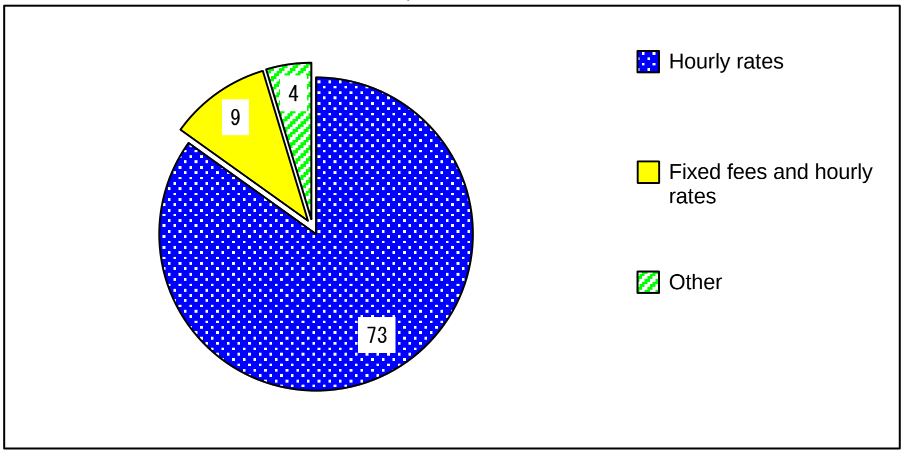
Approach	Method for calculating audit fee estimates
Hourly rates	Audit fees are calculated by multiplying the rates charged by the CPAs, assistant CPAs, and other personnel (hereinafter referred to as the "charged rate") by the times they spend performing the audit.
Fixed fees and hourly rates	Audit fees comprise two components: the fixed fee (a fixed amount) and the hourly rates (a variable amount). The fixed fee is determined based on the factors such as the type of audit (the FIEA audit, the Companies Act audit, etc.) and the size of audited companies (capital, assets, sales, etc.), while the hourly rates are calculated by multiplying the time spent on the audit by the charged rate.

Source: "Guidelines for the Calculation of Audit Fees," JICPA

The collected reports indicate that most audit firms employ the hourly rate approach for audit fee estimates, and all the large-sized audit firms employ this approach.

Similarly, most second-tier and small and medium-sized audit firms also take the hourly rate approach, but some use the fixed fees and hourly rate approach. Several firms charge the same amount of fee as the predecessor auditor or the same fee as they charged in previous years (Figure III-4-2).

Figure III-4-2: Methods for calculating audit fee estimates (second-tier and small and medium-sized audit firms, unit: no. of firms)



There are two ways of determining the charged rate: one is the rate charged by position and the other is single rate.

Most of large-sized audit firms set a rate for each position respectively, while the majority of second-tier audit firms and small and medium-sized audit firms set a single rate that is irrespective of position (Figure III-4-3).

Figure III-4-3: Status of setting of rates for each position (second-tier and small and medium-sized audit firms)

Settings	No. of firms	Percentage
Rates set	28	38%
Rates not set	45	62%
Total	73	100%

At large-sized audit firms, the rate for each position is calculated to include indirect costs associated with firm management and quality control such as payrolls of administrative departments and IT-system-related expenses.

Second-tier audit firms and small and medium-sized audit firms employ as follows: (1) similar methods of calculation to those used by large-sized audit firms, (2) calculation methods in reference to the JICPA's surveys of audit firms and its rules on standard audit fees (which has now been abolished), or (3) using rates that they have charged in the past.

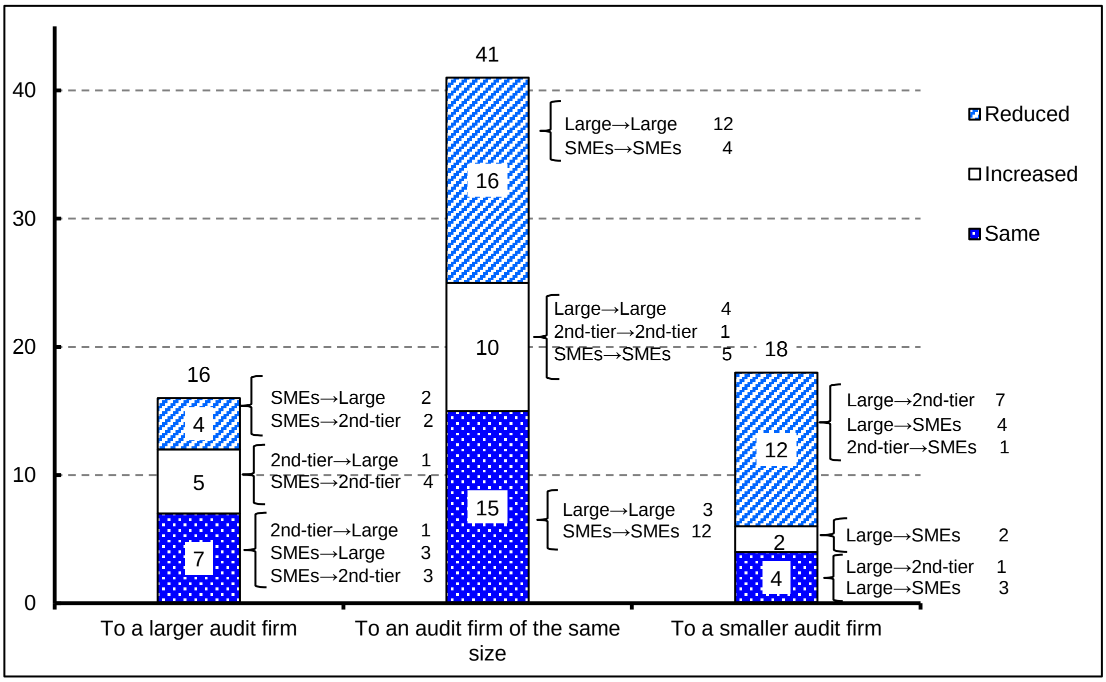
3. Audit Fees before and after Changes in Auditors

According to the factbook 2017 “Auditors of Listed Companies and Audit Fees” which was published by the JICPA, the average audit fees paid by the listed companies that were covered by the report declined between fiscal years 2008 and 2012 but have been on the increase since fiscal year 2013.

As audit fees are often reviewed when auditors are changed, the CPAAOB analyzed audit fees before and after changes in auditors. We found that the change in audit fees varies depending on the size of the new audit firms.

When switching to a larger audit firm, the audit fees often remain the same or increase. When switching to an audit firm of similar size, audit fees are reduced in around 40 percent of cases, but in the case of switches between large-sized audit firms, most of the switches (12 out of 19) saw a drop in audit fees, and this trend has been continuing since last year. When switching to a smaller audit firm, the audit fees fell in two-thirds of the cases (Figure III-4-4).

Figure III-4-4: Audit fees following changes in audit firms (unit: number of changes)



Note 1: Based on changes in auditors of domestic listed companies between the year to January 2015 and the year to December 2015 where the audit fees before and after the changes were publicly disclosed. A change of one million yen or more in fees is counted as an increase or reduction.

Note 2: Changes resulting from the merger or transfer of independent auditors (15 changes) were not included in the analysis.

Note 3: The breakdown of changes is shown in the graph form.
Sources: Timely disclosures concerning changes in independent auditors and annual securities report

■Case of a Fall in Audit Fees Following a Change in Auditors■

Among the changes between large-sized audit firms, there was a case where an audit firm presented an estimate for audit fees without taking into account the fact that the time required for the audit would be higher due to it being the initial audit engagement and changes in accounting standards. In this case, the successor auditor earned lower audit fees than the predecessor auditor's, and the actual time taken to perform the audit was far longer than that had been estimated.

4. Degree of Dependence on Fees (Safeguards)

An audit firm may, out of fear of losing an audit engagement, pursue its own gain at the expense of independence or become susceptible to unreasonable pressure in the audit firm's degree of dependence, which means that the proportion of the revenue from a specific audited company in the total revenue of audit firm etc. reaches a certain percentage.

The JICPA's "Guidelines on Independence" stipulate that if an audit firm has been dependent on an audit fee from the particular listed company for more than 15 percent of its whole revenues for two straight terms, it must examine whether it would be prudent to institute one of the following safeguards:

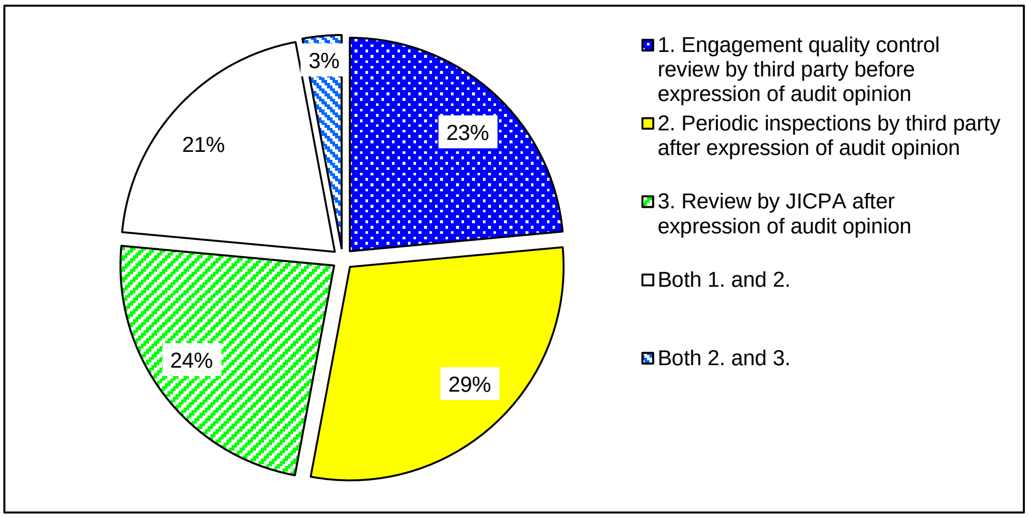
- Before expressing its audit opinion for the second or subsequent years, request an auditor that is not a member of the audit firm to conduct an engagement quality control review of the audit

- Between expressing its audit opinion for the second or subsequent years and before expressing its audit opinion for the next fiscal year, request an auditor that is not a member of the audit firm to conduct the inspection in relation to quality control, or ask the JICPA to conduct a review of the audit

Regarding the performance of safeguards, large-sized audit firms did not conduct ones. One second-tier audit firm (1 engagement) and 29 small and medium-sized audit firms (34 engagements) performed safeguards related to the degree of dependence among the 87 audit firms that were subject to inspections or collection of reports in program year 2016.

The second-tier audit firm mentioned above accepted an engagement quality control review by a third-party auditor before the expression of an audit opinion and was also reviewed by the global audit network the firm affiliated with. Most of the small and medium-sized audit firms, meanwhile, responded by having the inspection in relation to quality control or engagement quality control review before the expression of an audit opinion by a third-party auditor (Figure III-4-5).

Figure III-4-5: Safeguards (small and medium-sized audit firms)



■Example of Safeguards■

A small and medium-sized audit firm requested an auditor, who is not a member of the audit firm, to conduct the inspection in relation to quality controls of the engagement since the audit firm had been dependent on the particular audited company for more than 15 percent of its revenues for two straight terms. Deficiencies identified during our inspection were not detected by that inspection done by the third-party auditor because the auditor had not performed audit services for a long period of time.

E. Audit Services

Audit services are handled by individual engagement teams. It is essential for raising the level of quality of audit that engagement teams demonstrate proper professional skepticism, perform appropriate risk assessments and perform proper audit procedures. The CPAAOB endeavors, through its inspections of individual audit engagements, to understand the situation within the engagement team. In addition, we attempt to understand the conduct of audit services through our other monitoring activities.

In this section, we will analyze engagement teams identified through our monitoring activities as well as group audits, the importance of which has been increasing in conjunction with the diversification and internationalization of audited companies in recent years.

1. Engagement Teams

Engagement teams comprise an engagement partner, CPAs and other assistants who perform audits under instructions by the engagement partner. These other assistants include other professional staff and audit support staff who do not have CPA qualifications, etc (hereinafter, the CPAs and the other assistants are referred as to “other team members”). An example of the role by position seen in an engagement team at a large-sized audit firm is shown in Figure III-5-1.

Figure III-5-1: Example of roles of members of an actual engagement team

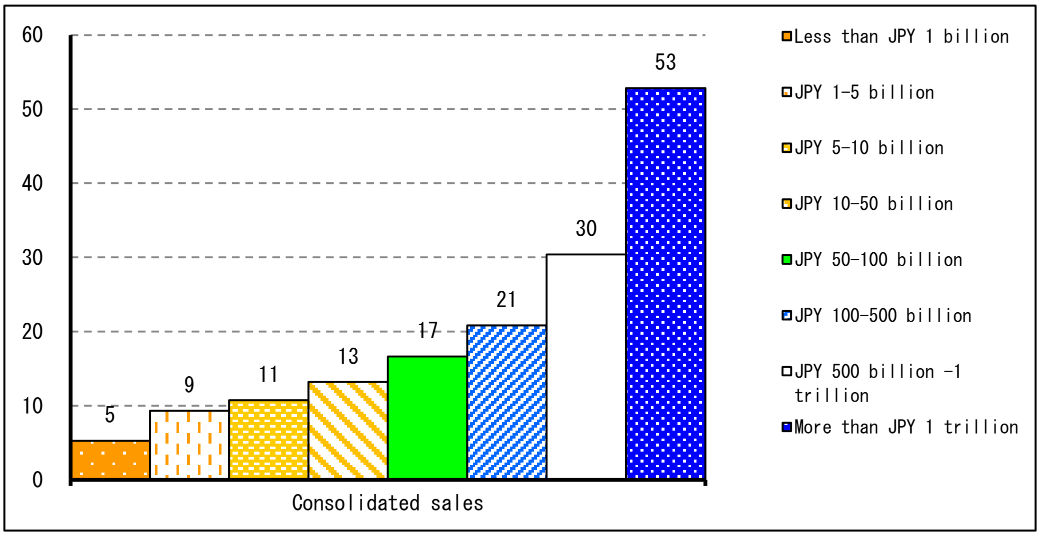
	Position	Main roles
Engagement partner A	Partner	Communication with the senior management of the audited company
Engagement partner B	Partner	Management of the audit services
Engagement partner C	Partner	Communication with foreign component auditors
CPA A	Senior manager	Management of the audit of financial statements and communication with the general manager of accounting department of the audited company
CPA B	Manager	Management of the audit services of internal controls
CPA C	Manager	Management of the work of foreign component auditors
15 other CPAs	Senior staff	Performance of audit procedures in significant areas of the audit
20 other professional staff	Staff	Performance of procedures for assessing the design and effectiveness of internal controls, performance of general audit procedures

	Position	Main roles
5 other audit assistants (audit support staff)	Assistant	Data analysis, tasks that do not involving important judgments (e.g., vouching), collection of confirmation statements, administration of audit documentation

Source: CPAAOB (Prepared based on the example of an engagement team with consolidated sales of around JPY 1 trillion and audit hours of approximately 7,000 hours. The job levels are based on the firm's internal rules.)

Regarding the number of engagement partners, three or more are sometimes assigned to companies with sales that exceed 500 billion yen, but for most companies, only one or two are assigned. However, the number of other team members tends to be higher, the higher the sales of audited companies are, and the graph below shows the numbers of other team members assigned to the companies that are required to receive an audit pursuant to the FIEA in fiscal year 2016 categorized by sales (Figure III-5-2):

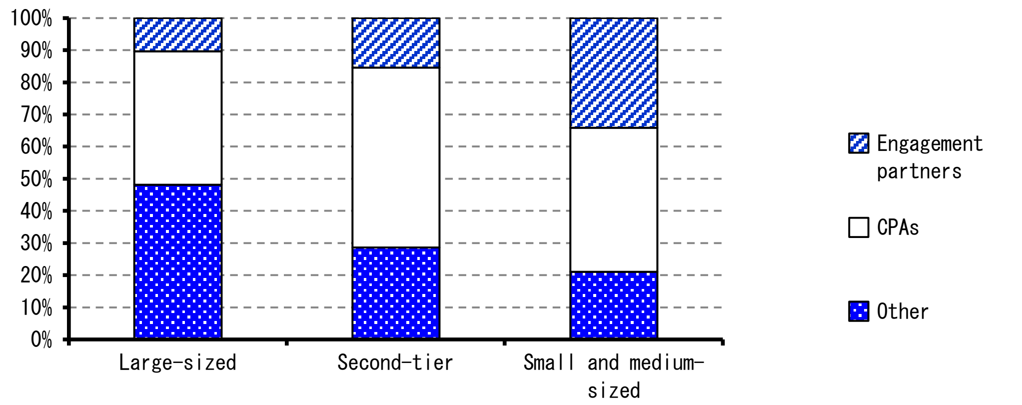
Figure III-5-2: Average number of other team members assigned to audited companies with different levels of consolidated sales (unit: number of persons)



Source: Based on data from 4,061 companies that was obtained from their 2016 annual securities report..

The composition of engagement teams depends on the size of the audit firm. Larger firms tend to involve other team members more (Figure III-5-3). This trend seems that the larger an audited company is, the more likely it is to be audited by a large-sized audit firm, and the number of other team members in the engagement team will be higher (See Figure II-3-3 and Figure II-3-4.).

Figure III-5-3: Comparison of the number of engagement team members by sizes of audit firms



Source: Audit summary statements (based on 2016 data from 35 firms that submit the annual securities reports under the FSA's "Other textile industry" category)

Typical characteristics concerning each of the job levels seen in engagement teams, as gleaned from our inspections, are as follows (Figure III-5-4). At large-sized audit firms, the audit tasks are assigned according to job level, with high-risk audit areas being handled by high-level personnel and low-risk, relatively broad audit areas being covered by other team members (including personnel who do not possess a qualification related to the CPA qualification).

Figure III-5-4: Typical engagement team composition and main roles of team members at audit firms of different sizes

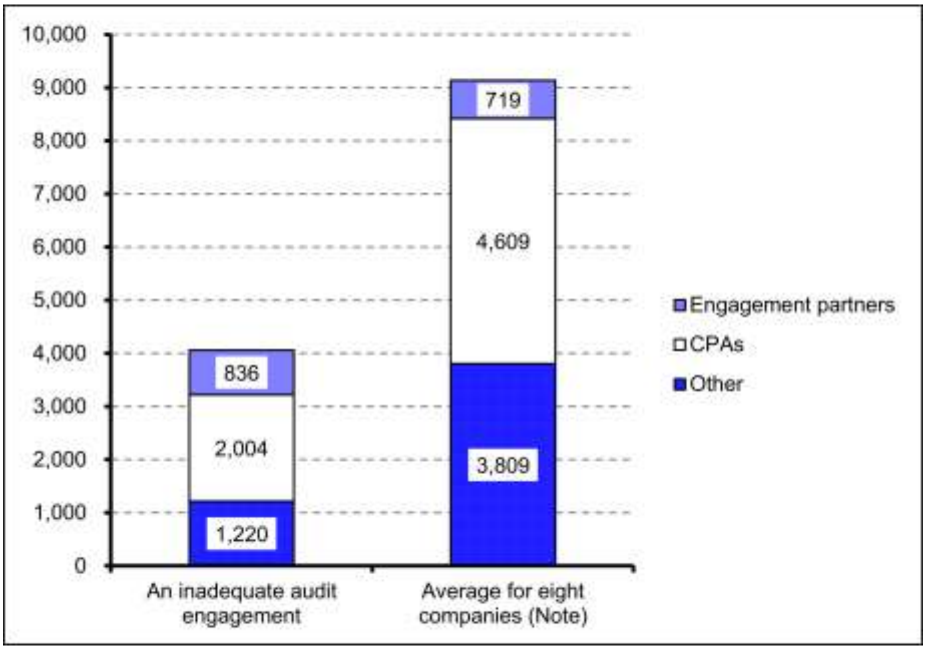
	Large-sized	Second-tier	Small and medium-sized
Engagement partners	・Decision-making in significant audit areas and risk assessment ・Review of audit procedures performed by other team members ・Communication with management, company auditors, etc.	・Decision-making in significant audit areas and risk assessment ・Review of audit procedures performed by other team members ・Performance of audit procedures in significant audit areas ・Communication with management, company auditors, etc.	・Decision-making in significant audit areas, risk assessment, and drafting of audit plans ・Review of audit procedures performed by other team members ・Performance of audit procedures ・Communication with management, company auditors, etc.
CPAs	・Audit plans ・Performance of audit procedures in significant audit areas Review of audit procedures performed by other assistants	・Audit plans ・Performance of audit procedures ・Review of audit procedures performed by other assistants	・Performance of audit procedures ・Review of audit procedures performed by other assistants
Other	・Performance of audit	・Performance of audit	・Performance of audit

	Large-sized	Second-tier	Small and medium-sized
professional staff	procedures	procedures	procedures ・Not employed in most of small firms
Audit support staff	・Data analysis ・Collection of confirmation statements, administration of audit documentation	・Data analysis ・Collection of confirmation statements, administration of audit documentation	・Not employed in most of firms

■Example Concerning Audit Hours■

During an inspection of a small and medium-sized audit firm, a case was supposed that audit hours were inadequate given the size of an audited company at an individual audit engagement in which various deficiencies including significant deficiencies were found. We therefore selected eight audited companies of similar size in the same industry, and compared the audit hours for each. As shown below, the total audit hours spent on this audit engagement were less than half of the average hours spent on the other eight companies, while the audit hours the engagement partners spent was higher (Figure III-5-5). On a side note, the auditors of the other eight companies were large-sized audit firms.

Figure III-5-5: Audit hours spent on an inadequate individual audit engagement compared with the average hours spent on a similar sized engagements (unit: hours)



Note: Average of the time taken for audits (years to March and December 2016, not including quarterly reviews) of eight companies in the same industry as and with similar consolidated sales (two companies had higher consolidated sales) to the company subject to the inadequate audit engagement.

2. Group Audits

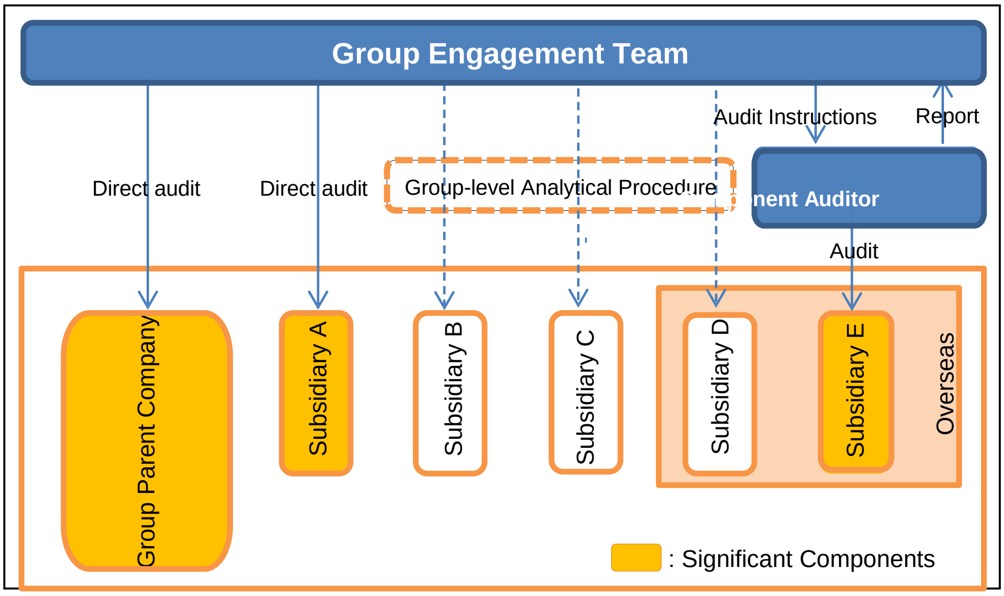
In recent years, more and more companies have been expanding overseas and operating businesses in other countries. In association with that expansion, material accounting frauds have arisen at foreign subsidiaries under circumstances that companies face, such as establishing governance of foreign subsidiaries, considering complex economic transactions and adapting to differences in accounting standards. Importance of group audits has been growing, and the CPAAOB has also focused on group audits as a key area for its inspections. In this section, we will provide an overview of group audits and describe the audit procedures that they involve.

a. Overview of Group Audits

When the auditor of a parent company (group engagement team) performs an audit and attestation of the consolidated financial statements, the audit covers not only the parent company but also its subsidiaries and affiliates. Subsidiaries and affiliates are classified as either "significant components" or "components that are not significant components" depending on factors such as their financial importance and significant risks, and group engagement teams determine the audit procedures that shall be performed for each category of component (ASCS 600 (8), (23), (25), (27)).

The following figure illustrates typical group audit procedures (Figure III-5-6):

Figure III-5-6: Overview of typical group audit procedures



b. Determination of Significant Components

When determining the significant components, the group engagement team is required to employ an understanding of the company and its operating environment to identify and assess the risks of material misstatement (ASCS 600 (16)). During this process, the key members of the engagement team need to discuss the possibility of there being a material misstatement in the financial statements due to fraud or error, and must focus in particular on the risks of material misstatements resulting from fraud.

If a component is deemed to be financially important, or it is deemed that a component contains significant risks in relation to the group financial statements, the group engagement team needs to identify the component as a significant component and prepare the audit plan based on this risk assessment.

■Example of Efforts to Improve Group Audits■

Some of large-sized audit firms emphasize during training that when selecting significant components, it is essential not only to look at the quantitative significance of components as measured by financial criteria, but also to consider qualitative significance since the incidents that required to restate prior-year financial statements due to issues occurred at components that are not significant components.

c. Audit Procedures for Significant Components

Group engagement teams need to conduct audit procedures for significant components. However, it is a general way to ask a local auditor to perform the audit procedure when the group engagement team is under certain restrictions on conducting the audit procedures such as a significant component is located overseas. In such cases, they need to provide the local auditor of the significant component with audit instructions covering the scope of work that shall be completed, the purpose for which the results of the audit will be used, and the format for and content of the report from the local auditor to the group engagement team (ASCS 600 (39)).

The approaches to group audit procedures taken by audit firms of different sizes are as follows (Figure III-5-7):

Figure III-5-7: Approach to group audit procedures taken by audit firms of different sizes

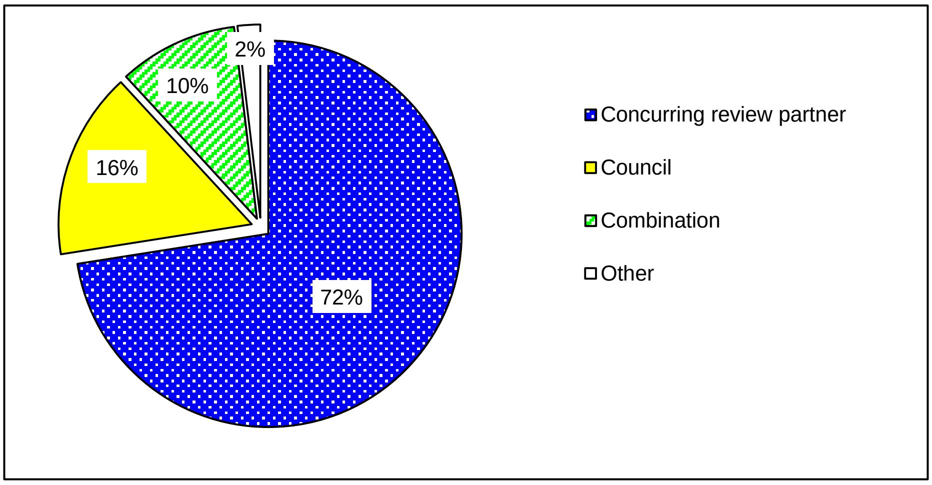
	Large-sized	Second-tier	Small and medium-sized
Group audit manual	Share a group audit manual with the global audit network	Share a group audit manual with the global audit network or prepare their own	Typically do not share a group audit manual with the global audit network
Audit instructions	Share a template for audit instructions with the global audit network	Share a template for audit instructions with the global audit network or prepare their own	Typically prepare their own template for audit instructions, but some have established business partnerships with large-sized audit firms and use the templates they provide

F. Engagement Quality Control Review

The reporting standards included in auditing standards require that an engagement quality control review be performed with respect to the expression of an audit opinion, and the review can be regarded as the final stage in the process of expressing an appropriate opinion. Whether an appropriate engagement quality control review is performed has a significant impact on audit quality as it concerns the objective assessment of important audit judgments and the expression of an opinion relating to the audit engagement.

There are three main forms of engagement quality control reviews adopted by audit firms: i) the concurring review partner form (a review is performed by a partner other than the engagement partner, ii) the council form (an engagement quality control review is performed under the council system), and iii) the combination form (an engagement quality control review is performed by a concurring review partner, and certain significant matters in expressing audit opinions, which are clarified in advance, are discussed and reviewed at the council). The forms of engagement quality control review are shown below (Figure III-6):

Figure III-6: Forms of engagement quality control review (FY2015)



Note: Based on data from 211 audit firms.

Most large-sized audit firms and second-tier audit firms conduct engagement quality control reviews using the combination form. Around 70 percent of small and medium-sized audit firms, however, employ the concurring review partner form, though some perform engagement quality control reviews using the council form or the combination form.

■Example of an Identified Deficiency in Engagement Quality Control Reviews■

The CPAAOB identified at our inspection that a small and medium-sized audit firm concluded reviews for audit services without review of its audit documentation relating to important judgements such as significant risks. The reviews were performed once a month using the council form, but the council members orally discussed only review documents.

G. Monitoring in System of Quality Control

Audit firms are responsible for maintaining and improving audit quality, and it is important that they take initiatives for improving audit quality.

Therefore, it is important for audit firms to understand and improve the quality control level of audit engagements. The CPAAOB inspects the monitoring of audit firm's system of quality control.

Furthermore, recent years have seen audit firms, particularly large ones, having inspections from the global audit networks that they belong to as monitoring in relation to quality control. In this section, we will perform an analysis of this situation.

1. Periodic Inspection

Once an audit engagement has finished, the audit firm must conduct procedures to ascertain whether the professional staff performed audits in accordance with the system of quality control prescribed by the audit firm (the inspections in relation to quality control). This inspection must be performed for at least one of the audit services that each engagement partner has conducted during a certain period (QCSCS (47)).

Although the inspections in relation to quality control are being conducted at all audit firms, factors such as the number of inspections, the number of people involved and tools used differ depending on the size of the firm (Figure III-7-1).

Furthermore, regardless of their size, at all firms the results of the inspections and details of the identified deficiencies are provided to the members at each firm to serve as feedback.

Moreover, the inspection results are usually reflected on evaluation of partners at large-sized audit firms.

Figure III-7-1: Overview of periodic inspections conducted in FY2016

	Large-sized	Second-tier	Small and medium-sized
No. of and method of selection of audit engagements to be inspected	Each engagement partner is subject to an inspection at least once every three years. Additional inspections may also be performed based on the size and complexity of audited companies.	Each engagement partner is subject to an inspection at least once every three years. Additional inspections may also be performed based on the size and complexity of audited companies.	Each engagement partner is subject to an inspection at least once every three years.
Inspectors	The partner in charge of quality control and other partners and assistants who are not involved in audit engagements for inspection (sometimes a dedicated team is established).	The partner in charge of quality control and other partners and assistants who are not involved in audit engagements for inspection. A third-party CPA or the JICPA inspect the engagement on which is applied safeguards relating to a high degree of dependence.	The partner in charge of quality control or the partner and other personnel appointed by him/her A third-party CPA or the JICPA inspect the engagement on which is applied safeguards relating to a high degree of dependence.
No. of inspectors	Between around 30 and 160 persons	From a few to around 20 persons	A few persons
No. of engagements handled by each inspector	Typically around three to five engagements, but some firms have each inspector handle around 30 engagements	From a few to between 10 and 20 engagements	A few engagements
Inspection tools	Tools provided by the global audit network to which the firm belongs or tools developed in-house are used	Typically tools developed in-house are used	Documents such as the “JICPA Checklist for the inspection in relation to quality control” and “Audit Service Review Procedures” are used
Use of inspection	Inspection results are shared	At some firms, inspection	Inspection results are shared

	Large-sized	Second-tier	Small and medium-sized
results	within the firm and reflected in evaluation of partners and personnel.	results are shared within the firm and reflected in evaluation of partners and personnel.	within the firm.

■Example of an Identified Deficiency in Periodic Inspections■

During an inspection of a small and medium-term audit firm, we found that numerous deficiencies in individual audit engagements were being overlooked because the personnel conducting the periodic inspections did not understand either the importance of the inspections or the level of procedures required under current auditing standards. Therefore, the personnel only pointed out cosmetic deficiencies such as a lack of documentation.

2. Utilization of Global Reviews

Most of global audit networks assign their reviewers for their member audit firms to perform global reviews aimed at confirming that local audit services are being conducted in accordance with the network's policy.

Whether or not global reviews are performed generally depends on using the network's audit manual. Whereas all large-sized audit firms and second-tier audit firms have global reviews, most of the small and medium-sized audit firms that are members of global audit networks, 22 firms, do not receive ones (Figure III-7-2).

Figure III-7-2: Overview of global reviews

	Large-sized	Second-tier	Small and medium-sized
Experience of global reviews	Yes (reviewed)	Yes (reviewed)	Most of them are not reviewed
Frequency of global reviews	Every year	Every year to once every four years	Typically once every three years
Method for global reviews	In some cases the global review is performed as a direct investigation, while in others the results of domestic periodic inspections are reviewed indirectly.	In most cases the global review is performed as a direct investigation.	In most cases the global review is performed as a direct investigation.

Note: The number of small and medium-sized audit firms that are members of global audit networks is small. See A. Operations Management Environment, 5. Ties with Global Audit Networks for details.

■Example Relating to Global Reviews■

At a large audit firm, global reviews were the main method employed for periodic inspections, and that personnel from overseas member firms conducted the reviews with a focus on areas that are important from a global standpoint. During the inspection, we found that the audit firm didn't consider the characteristics of global reviews in using it as the firm's periodic inspection.

H. Foreign Audit Firms Etc.

1. System for Foreign Audit Firms Etc.

Financial statements, which shall be submitted under the provisions of the FIEA by an issuer company of listed securities, must generally require an audit certification by a CPA or audit firm that has no special interest in the issuer company (Article 193-2 of the FIEA).

If the issuer company is a foreign company, the financial statements normally undergo audit certification by a CPA or audit firm in the home country. Therefore, to avoid duplicate audits, an exception is granted in cases where the issuer company has received an audit certification deemed to be equivalent to that prescribed under the FIEA because it was issued by a party equivalent to a Japanese CPA or audit firm. In such cases, the issuer company does not need to receive an audit certification under the FIEA.

With the aim of further enhancing the soundness of Japan’s capital markets, the Act was amended in 2007 to require foreign CPAs and audit firms that audit the financial statements of foreign companies, etc., that are subject to FIEA disclosure rules to register with the Commissioner of the FSA.

Audit firms that have submitted this registration are regarded as foreign audit firms, etc., (foreign audit firms) (Article 1-3 (7), Article 34-35 (1) of the Act) and are subject to inspection and supervision by the CPAAOB and FSA.

2. Foreign Audit Firms Etc.

Regarding the locations of foreign audit firms that have registered with the FSA, the largest number are based in Europe, with the second largest number being headquartered in the Asia-Pacific region (Figure III-8-1).

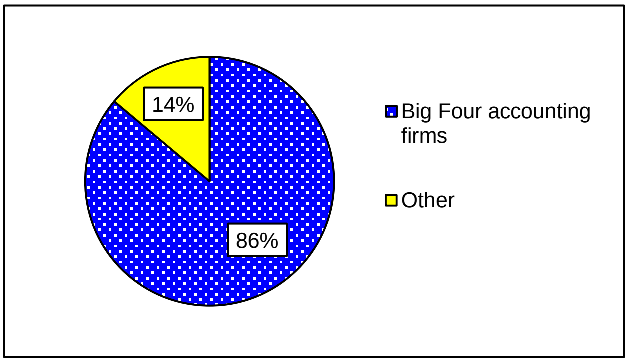
Figure III-8-1: No. of registered foreign audit firms, etc. (as of March 31, 2017)

	No. of countries/regions	No. of audit firms, etc.
Europe	15	43
Asia-Pacific	10	27
North America	3	15
Central and South America	2	2
Middle East	1	1
Total	31	88

Among the foreign audit firms from which reports have been collected by the CPAAOB, around 90 percent are affiliated with one of the Big Four accounting firms.

Those foreign audit firms receive periodic global reviews, and are expected to maintain the level of audit quality demanded by the network. On the other hand, not many foreign audit firms that are affiliated with a global audit network other than the Big Four are subject to periodic global reviews. Instead, the activities mainly focus on the exchange of information among network firms (Figure III-8-2).

Figure III-8-2: Affiliation with global audit networks (unit: number of firms, as of September 1, 2015)



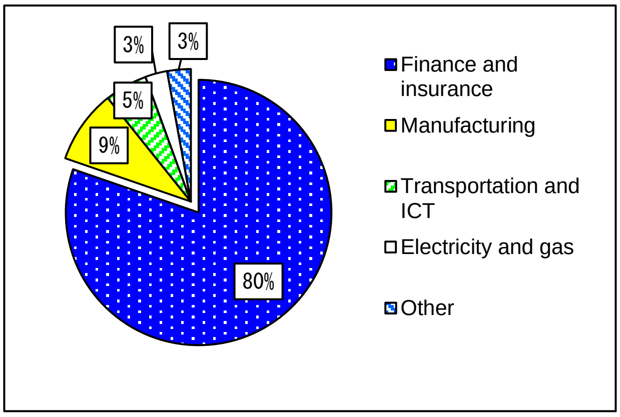
Big Four accounting firms	62
Other	10
Total	72

3. Audited Companies

Securities that relate to the financial statements of foreign companies that are subject to FIEA disclosure rules include not only shares issued by companies listed in Japan (listed foreign companies), but also bonds issued by foreign companies, beneficiary certificates issued by foreign investment trusts, and foreign investment securities, and most of them are unlisted foreign investment trust beneficiary certificates and foreign investment securities.

Regarding the industries of companies audited by foreign audit firms from which we have collected reports, 80 percent are classified as banking or insurance, and most of these are unlisted funds (Figure III-8-3).

Figure III-8-3: Industries of audited companies (unit: number of companies; as of September 1, 2015)



Finance and insurance	448 (9)
Unlisted funds	337
Manufacturing	50 (3)
Transportation and ICT	29(-)
Electricity and gas	15 (-)
Other	16 (1)
Total	558 (13)

Note: Figures in parentheses are the number of companies (including funds) that are listed in Japan.

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